No. 00-511

Supreme Court, U.S.
FILED
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IN THE
Supreme Court of the United States
OCTOBER TERM, 2000

VERIZON COMMUNICATIONS INC., *ET AL.*,*
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

LIST OF PARTIES AND RULE 29.6 STATEMENT

The Petitioners in this Court are:

Verizon Entities, consisting of:

Verizon Communications Inc.
GTE Service Corporation
GTE Alaska Incorporated
GTE Arkansas Incorporated
Verizon California Inc. (f/k/a GTE California Incorporated)
Verizon Florida Inc. (f/k/a GTE Florida Incorporated)
GTE Midwest Incorporated
Verizon South Inc. (f/k/a GTE South Incorporated)
GTE Southwest Incorporated
Verizon North Inc. (f/k/a GTE North Incorporated)
Verizon Northwest Inc. (f/k/a GTE Northwest Incorporated)
Verizon Hawaii Inc. (f/k/a GTE Hawaiian Telephone Company Incorporated)
Verizon West Coast Inc. (f/k/a GTE West Coast Incorporated)
Contel of Minnesota, Inc.
Contel of the South, Inc.

BellSouth Corporation
SBC Communications Inc.
United States Telecom Association

The parties to the proceedings in the Eighth Circuit are listed in the caption of the decision below, *see* Appendix A to the Petition for Writ of Certiorari, and in Appendix F to the Petition for a Writ of Certiorari.

Pursuant to Supreme Court Rule 29.6, Petitioners state as follows:

On June 30, 2000, GTE Corporation and Bell Atlantic Corporation closed their merger, and Bell Atlantic Corporation subsequently changed its name to Verizon Communications Inc. Verizon Communications Inc. is the ultimate parent of each of the other Verizon Entities listed above. No publicly

owned company owns 10% or more of the stock of Verizon Communications Inc.

SBC Communications Inc. has no parent company, and no publicly owned company owns more than 10% of its stock.

BellSouth Corporation has no parent company, and no publicly owned company owns more than 10% of its stock.

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INTRODUCTION

The local telephone network represents one of the largest private capital investments in this country. This massive investment was induced by a regulatory regime that offered shareholders the opportunity to recover prudent investment plus a reasonable return through retail telephone rates. The Telecommunications Act of 1996 gives competitors the right to exclusive use of portions of that network to provide their own telephone service. At the same time, the Act mandates that "just and reasonable" rates be established for this new use, and further specifies that these rates must recover "the cost . . . of providing" the network element and "may include a reasonable profit." 47 U.S.C. § 252(d)(1). The Act creates a new wholesale market for network elements and provides a mechanism whereby the competitors who profit from using these elements must fully compensate the incumbent owners.

The FCC has now declared that "the cost" of providing ongoing use of this capital-intensive network cannot include any recovery of past capital investment. The FCC has thus rewritten "cost" to mean "value," and has equated value with its own speculation as to what it might cost to provide a hypothetical network that is continuously updated with instantaneous and ubiquitous deployment of the most up-to-date technology in an optimally efficient design. With a stroke of the regulatory pen, the FCC has decreed that the existing network is worth about half of what it was the day before. The FCC's action results in systematic undercompensation of incumbent carriers for the network elements they are compelled to provide competitors. It contravenes the text and purpose of the statute and the constitutional standard of just compensation incorporated in it.

OPINIONS AND ORDERS BELOW

The court of appeals' decision is reported at 219 F.3d 744, and is reprinted in the appendix to the petition for certiorari ("Pet. App.") at pages 1a-43a. The Local Competition Order, *In re Implementation of the Local Competition Provisions of*

the Telecommunications Act of 1996, First Report and Order, is reported at 11 F.C.C.R. 15,499.

JURISDICTION

The court of appeals had jurisdiction pursuant to 28 U.S.C. § 2342(1) and 47 U.S.C. § 402(a). The Eighth Circuit issued its opinion and judgment on July 18, 2000. Petitioners timely filed a petition for certiorari on October 4, 2000. This Court has jurisdiction under 28 U.S.C. § 1254(1).

PERTINENT CONSTITUTIONAL AND STATUTORY PROVISIONS

This case involves the Takings Clause, U.S. Const. amend. V ("nor shall private property be taken for public use without just compensation"); sections 251 and 252 of the Telecommunications Act of 1996, 47 U.S.C. §§ 251, 252; 5 U.S.C. § 706; and 47 C.F.R. §§ 51.501-51.511. The statutory provisions are reproduced in the appendix to this brief.

STATEMENT

A. The Regulatory Background Prior to 1996

For most of the twentieth century, local telephone service was treated as a natural monopoly and was provided under a system of exclusive local franchises. Typically, a State granted a single company (now known as the incumbent local exchange carrier or incumbent "LEC") an exclusive franchise to provide local telephone service within a designated area. *See AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 371 (1999). The incumbent was required to serve all customers within its service area and to make the massive investments necessary to satisfy this and other service mandates. For their part, regulators set retail rates designed to ensure that the incumbent had an opportunity to recover its costs plus a reasonable rate of return, as required by the Constitution. *See, e.g., Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 601-04 (1944).

Because the local network carries both intrastate and interstate calls, part of the cost of the local network has always been allocated to the federal jurisdiction, and the Federal Communications Commission ("FCC") has set charges associated with interstate calls sufficient to recover those costs. Thus, for decades state and federal regulators have been responsible for setting rates that allow incumbents to recover their costs and make a reasonable rate of return.

For over 60 years, both state and federal regulators have used cost-of-service ratemaking based on historical (or "embedded") costs to ensure adequate compensation. Under this method, regulators generally set rates to recover the full amount of prudently invested capital. *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309 (1989). The theory behind this method is that the measure of value of the property dedicated to public use (and hence what the government must pay for) is not the value of the physical equipment, which might fluctuate over time, but rather the amount of capital invested, which is fixed once the investment is made. *See, e.g., Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 290 (1923) (Brandeis, J., joined by Holmes, J., concurring).

In the years leading up to the 1996 Act, some States and the FCC began to adopt a modified version of historical cost ratemaking through a system known as "price caps." Under this system, an incumbent's current rates (which were set to recover historical costs) are taken as a starting point and are adjusted downward each year by a factor reflecting expected productivity gains (and typically are adjusted upward to reflect an inflation index). *See generally USTA v. FCC*, 188 F.3d 521, 524 (D.C. Cir. 1999). By determining rates through these adjustments, which place "caps" on prices, this system eliminates the need to redetermine periodically a carrier's costs. Nevertheless, because the system uses rates designed to recover historical costs as its baseline and modifies them to reflect

productivity gains based on actual industry data, it still provides incumbents an opportunity to recover historical costs. *See In re Access Charge Reform*, 12 F.C.C.R. 15,982, ¶ 27 (1997); Brief for FCC at 8-9, *Texas Office of Pub. Util. Counsel v. FCC*, 183 F.3d 393 (5th Cir. 1999) (No. 97-60421).

Regulators have also used their control over incumbents' rates to pursue a social policy known as "universal service." To ensure that all Americans receive basic telephone service at affordable rates, regulators set rates for residential and rural customers substantially below cost. They then set rates for business and urban customers well above cost to subsidize the below-cost rates. *See* Report & Order, *In re Federal-State Joint Board on Universal Service*, 12 F.C.C.R. 8776, 8784 ¶ 11 (1997) (hereinafter "Universal Service Order"). These implicit cross-subsidies have created lopsided markets in which incumbents often served the bulk of customers below cost while relying on a narrow segment to make up the difference.

A second way in which regulators kept basic rates low was by extending the depreciation lives of incumbents' equipment. By ignoring the economic lives of assets, regulators could reduce costs to be recovered in current rates by pushing recovery into the future. As a result, as the FCC has admitted, incumbents accumulated significant "depreciation reserve deficiencies" on their books, reflecting that the undepreciated value of some equipment exceeds its economic value.[1]

[1] *See* J.A. 364-65 (¶ 659 n.1633); *see also* Comments of the United States Tel. Ass'n at 74, *In re Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 96-262, *et al.* (filed Jan. 29, 1997) (estimating depreciation reserve deficiency for large LECs at $17.9 billion); Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation, or: Temptation of the Kleptocrats and the Political Economy of Regulatory Disingenuousness* 7-8 (1998) (describing the "grossly inadequate" depreciation rates set for incumbents).

The exclusive franchise was central to this regulatory regime. Only by restricting competitive entry could regulators ensure that the extra margin built into the rates of "high-value" customers would actually flow to the incumbent serving other customers below cost. If competition were allowed, implicit subsidies would become subsidies for new entrants – those entrants would "cream skim" away high-margin customers, pocket the margin, avoid serving high-cost customers, and "leave the incumbents holding the bag for universal service." *AT&T Corp.*, 525 U.S. at 393.

B. The Telecommunications Act of 1996

The Telecommunications Act of 1996 (the "Act") was prompted by a growing recognition that alternative facilities and technologies were emerging that would make competition possible among multiple providers of local telephone service. These alternative systems included cable networks that could be upgraded for providing telephony, fiber networks in urban centers, and fixed wireless loops.[2] The premise of the Act was that the local market was no longer a natural monopoly and that more than one firm could efficiently provide local service. *See AT&T Corp.*, 525 U.S. at 371-72.

[2] *See, e.g.*, H.R. Rep. No. 104-458, at 148 (1996) (cable service is available to 95% of American homes and "[s]ome of the initial forays of cable companies into the field of local telephony therefore hold the promise of providing the sort of local residential competition that has consistently been contemplated"); Connecticut Research, 1995/96 Local Telecommunications Competition, at IV-2 (7th ed. 1995) ("Cable TV providers, long distance companies, and the new C-LECs . . . were all announcing plans to offer a pretty full array of telecommunications services to almost all classes of telecommunications customers."); P. Huber, M. Kellogg & J. Thorne, *The Geodesic Network II: 1993 Report on Competition in the Telephone Industry* 2.54 ("The cable industry is now moving fast toward two-way capabilities and a head-on challenge to the telephone's hegemony in two-way communications.").

The purpose of the Act, therefore, was to encourage the development of this emerging facilities-based competition. Congress explicitly proceeded on the assumption that "meaningful facilities-based competition is possible," H.R. Rep. No. 104-458, at 148 (1996), and intended the "opening [of] all telecommunications markets to competition" to "accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services," *id.* at 113. The FCC has acknowledged that the "most substantial benefits to consumers" promised by the Act "will be achieved through facilities-based competition." *Promotion of Competitive Networks in Local Telecommunications Markets*, Notice of Proposed Rulemaking, FCC No. 99-141, 14 F.C.C.R. 12,673, ¶ 4 (1999).

To allow competition, the Act terminated the incumbents' exclusive franchise and prohibited other state-imposed barriers to entry. *See* 47 U.S.C. § 253(a). To further foster the development of facilities-based competition, the Act imposed three new duties on incumbents vis-à-vis their competitors.

First, the Act required each incumbent to allow other carriers to "interconnect" their facilities with the incumbent's network. *See id.* § 251(c)(2). That requirement ensured that entrants could achieve ubiquity (*i.e.*, the ability for their customers to call and be called by all telephone subscribers) without replicating the incumbent's entire network.

Second, Congress required incumbents to sell their retail services to new entrants at wholesale rates so that entrants could resell the services under their own brand names. *See id.* § 251(c)(4). Beyond just enabling "reseller" competition, this requirement was intended to foster facilities-based competition by allowing entrants to build sufficient scale to support investment in facilities.[3]

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[3] *Cf.* Reed Hundt, FCC Chairman, Antitrust and Interconnection: Old Wine in New Bottles, Remarks at Antitrust Conf. for Corp. General Counsels, 1996 WL 646783 (Nov. 8, 1996) (resale was a "competitive stepping stone to facilities-based competition" in long distance markets).

Third, Congress required incumbents to provide competitors access to certain pieces of their networks, known as "unbundled network elements" or "UNEs." *See id.* § 251(c)(3). This requirement was intended to encourage the rapid deployment of new facilities by ensuring that new entrants could begin to compete even if they had only partial facilities and needed to rely in part on elements leased from the incumbent's network.

The incumbents' duty to provide UNEs is also subject to important restrictions. The Act directs the FCC to *limit* access to incumbents' UNEs to those elements that competitors genuinely need to obtain from the incumbent in order to compete. *See id.* § 251(d)(2). The Act also requires that incumbents be paid constitutionally sufficient compensation for forced uses of their property. The Act specifies that the prices for interconnection and UNEs shall be "just and reasonable," "shall be based on the cost . . . of providing the interconnection or network element," and "may include a reasonable profit." *Id.* § 252(d)(1)(A), (B). In addition, Congress used retail rates as the basis for wholesale prices, thereby preserving incumbents' ability to recover historical costs (which are reflected in retail rates). *See* H.R. Rep. No. 104-204, pt. 1, at 72 (1995) ("[I]t is the Committee's intent that there be a recognition of pricing structures for telephone exchange service in the State.").

Congress also recognized that, by abolishing the incumbents' exclusive franchises, it had made the old universal service system of implicit subsidies untenable. Congress therefore directed the FCC, after consultation with a Federal-State Joint Board, to establish new funding mechanisms that must be "specific, predictable and sufficient" to "preserve and advance universal service." 47 U.S.C. § 254(b)(5), (d). Congress also

demanded prompt action on these reforms and required the FCC to complete a proceeding to "implement the recommendations from the Joint Board" by May 1997. *Id.* § 254(a)(2).

C. The FCC's Local Competition Order

The FCC was dissatisfied with the 1996 Act. As then-Chairman Reed Hundt later admitted, the FCC thought the Act had not gone far enough to favor new entrants and was "tilted toward the local phone companies' advantage." Reed Hundt, *You Say You Want a Revolution* 154 (2000). Hundt believed that the FCC could use its "broad authority" in writing the implementing rules to change the balance struck in the Act: "like the modern engineers trying to straighten the Leaning Tower of Pisa, we could aspire to provide the new entrants to the local telephone markets a fairer chance to compete than they might find in any explicit provision of the law." *Id.*

On August 8, 1996, the FCC issued its Local Competition Order. Section 251 required the FCC to address two issues: (i) what parts of the network would be made available to entrants, and (ii) what the prices for those UNEs would be. On the first issue, as this Court has already determined, the FCC ignored the limiting standards set by Congress in section 251(d)(2). *See AT&T Corp.*, 525 U.S. at 387-92. Instead, the agency decreed virtually unlimited access to incumbents' networks. *See* J.A. 288, 292-94 (¶¶ 278, 286-287). The FCC thereby enabled an entrant to obtain, and resell, finished service through the fiction of buying a combined set of the incumbent's network elements – the so-called UNE platform or "UNE-P."

On pricing, the FCC categorically rejected incumbents' arguments that UNE prices should be set to allow incumbents the opportunity to recover historical costs. *See id.* at 375-76, 397-401 (¶¶ 672-673, 704-707). Instead, the FCC concluded that it should set prices by projecting the forward-looking costs of a hypothetical carrier that always uses throughout its

network only the most up-to-date technology deployed in the most efficient network configuration. *See id.* at 379-80, 382-84 (¶¶ 679, 683-685). The FCC dubbed the novel methodology it invented for projecting these costs "Total Element Long Run Incremental Cost" or "TELRIC." *Id.* at 378-79 (¶ 678). TELRIC's only concession to the reality of the existing network was that it assumed that wire centers would remain in the same location. *See id.* at 383-84 (¶ 685).

TELRIC completely ignores incumbents' past investments. The FCC's asserted justification for brushing aside these embedded costs was that incumbents were "inefficient" and that their historical costs would "reflect inefficient or obsolete network design and technology." *Id.* at 383 (¶ 684); *see also id.* at 375-76 (¶ 672); Universal Service Order ¶¶ 224-225, 228. And the FCC's express goal in adopting TELRIC was to produce dramatically *lower* prices than would be dictated by historical costs. *See* J.A. 399-400 (¶ 706) (historical costs would require "increasing the rates for interconnection and unbundled elements"); *id.* at 398-99 (¶ 705) (historical costs would favor incumbents by inflating prices). Indeed, potential entrants were clamoring for forward-looking costs precisely because they knew that the FCC's formula would produce substantially lower prices for UNEs. *See, e.g.*, *id.* at 340-42, 359-61 (¶¶ 635, 655); Comments of MCI Telecomms. Corp. at 63, 65, in *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (filed May 16, 1996) (prices using historical costs would be "higher than" prices using forward-looking costs; "rates based on historical costs are excessive").

The FCC ensured that TELRIC would yield lower prices by indulging in three assumptions that could not be met in any real-world market. *First*, TELRIC assumes that prices will always immediately reflect the costs of the most efficient technology and network configuration. *See* J.A. 383-84 (¶ 685). TELRIC thus hypothesizes a fantasy world in which carriers

would repeatedly rip out and instantaneously rebuild their entire plant every time a newer technology hits the market or a more efficient configuration could be achieved. The FCC has never disputed that such a fantasy carrier could never exist in reality, but it has nonetheless used this fiction to justify radical downward repricing of the existing network. *Second*, TELRIC contradictorily presumes that the economic depreciation rate for equipment would be the same as the extended depreciation rate used by regulators in the prior monopoly regime. *See id.* at 395-96 (¶ 702). *Third*, TELRIC similarly presumes that carriers in its fictional world of constant network replacement would nonetheless continue to have the same cost of capital established for incumbents in the stable, low-risk monopoly system of the past. *See id.* at 385-86, 395-96 (¶¶ 687-688, 702).

TELRIC had its intended effect: it produced massive price reductions from historical costs. The FCC itself set "proxy prices" that it said approximated TELRIC, and they resulted in 60% discounts from historical costs.[4] Moreover, the FCC *required* States to use those proxies until they had completed new TELRIC cost studies. *See* J.A. 326 (¶ 619). The FCC made clear that its proxies were *ceilings*. States could "select lower prices," but they were warned to provide justifications on the record "especially for setting a rate above a default proxy ceiling." *Id.* When state utility commissions began applying TELRIC, they typically produced discounts of 50% below historical cost.[5] Indeed, TELRIC projects that the entire local

[4] *See* Supplemental Aff. of Dennis B. Trimble, ¶¶ 17-18, in Appendix to GTE Service Corp.'s Motion for Stay Pending Judicial Review and for Expedited Judicial Review, *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997) (No. 96-3321) (J.A. 462-63).

[5] *See, e.g.*, Testimony of Dennis B. Trimble, GTE Corp., in *In re Petitions of AT&T Communications, et al., for Arbitration of Unresolved Issues from Interconnection Negotiations with GTE South, Inc. Pursuant to § 252 of the Telecommunications Act of 1996*, Virginia State Corp. Comm'n Case Nos. PUC960117, *et al.*, Tr. 726-28 (Nov. 21, 1996).

exchange infrastructure throughout the country could be rebuilt for about $180 billion – roughly half the $342 billion actually invested in the existing infrastructure[6] and only six times the amount that incumbents pour into capital expenditures on the network *each year*.[7]

Nor does TELRIC effect only a one-time downward revaluation of the network. Rather, incumbents are subject to further downward repricing of the network each time an entrant seeking network elements requests an arbitration under the Act. *See* 47 U.S.C. § 252(a), (b). Thus, through TELRIC, all incumbents' past and future investments are continuously subject to retroactive reclassification as "inefficient" and hence unrecoverable.

The FCC categorically determined that historical costs should not be included in UNE prices. It stated that including those costs would "interfere" with its policy goal of optimizing "efficient" competition. J.A. 399-400 (¶ 706). The agency determined that incumbents were not entitled to recover historical costs, *see id.* at 375-76, 397-401 (¶¶ 672, 704-707), and that precluding their recovery would not be confiscatory, *see id.* at 418-23 (¶¶ 733-740). At the same time, the FCC vaguely hinted that it might consider addressing some stranded historical costs in a future proceeding – which it has never done. In the Local Competition Order, the FCC suggested that

[6] TELRIC projects that, on average, it costs $885 per line to construct a local exchange network, and the FCC has projected that there are roughly 202.9 million access lines in the country. *See* Accounting Policy Division, Common Carrier Bureau, FCC, Hybrid Cost Proxy Model, Version 2.6, Revised Model Results: Wirecenter Support Spreadsheet (Jan. 20, 2000) <http://www.fcc.gov/ccb/apd/hcpm/wcsupport.xls>. *Compare 1999 Statistics of Communications Common Carriers* tbl. 2.7, at 42 (Aug. 11, 2000) (actual investment is $342 billion).

[7] *See 1999 Statistics of Communications Common Carriers* tbl. 2.7, at 42 (Aug. 11, 2000) (incumbents invested $29.5 billion in capital assets in 1999).

historical costs might be considered in the Universal Service Order. *See id.* at 400-01 (¶ 707). In the Universal Service Order, the FCC ignored recovery of historical costs but suggested it might consider the question in its Access Charge Order. *See* Universal Service Order ¶ 230 n.593. In its Access Charge Order, the FCC again made no provision for recovering historical costs and instead suggested yet again that it would consider the issue in a "separate order." *In re Access Charge Reform*, 12 F.C.C.R. 15,982, ¶¶ 14, 49 (1997). Not surprisingly, that order has never materialized.[8]

The FCC's rush to implement TELRIC as the price for UNEs sold by incumbents to competitors contrasts starkly with its sputtering implementation of TELRIC in reforming federal universal service funding. In explaining its four-year delay in implementing universal service reforms, the FCC asserted that the models available for calculating TELRIC were too

[8] In contrast, other agencies have forthrightly acknowledged that they must provide recovery of costs stranded by major changes in their regulatory regimes. FERC, for example, repeatedly recognized the need to provide for stranded cost recovery in its proceeding entitled Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities. *See, e.g.*, FERC Order No. 888, 61 Fed. Reg. 21,540, 21,630 (1996) ("[W]e believe that the utility is *entitled* to recover legitimate, prudent and verifiable costs that it incurred under the prior regulatory regime to serve that customer." (emphasis added)); FERC Order No. 888-A, 62 Fed. Reg. 12,274, 12,373 (1997) (recognizing that agency "cannot change the rules of the game without providing a mechanism for recovery of the costs caused by such regulatory-mandated change"); FERC Order No. 888-B, 62 Fed. Reg. 64,688, 64,688-89 (1997) (permitting recovery of "legitimate, prudent, and verifiable wholesale stranded costs"); *see also* Council of Economic Advisors, 1996 Economic Report of the President at 187 (GPO 1996) ("A strong case therefore can be made for allowing utilities to recover stranded costs where these costs arise from after-the-fact mistakes or changes in regulatory philosophy toward competition, as long as the investments were initially authorized by regulators.").

unreliable to be used. *See, e.g.*, Universal Service Order ¶¶ 244-245; *Federal-State Joint Board on Universal Service*, Fifth Report & Order, 13 F.C.C.R. 21,323, ¶¶ 3, 60 (1998).

When the FCC did act, it left completely intact the massive implicit subsidies embedded in intrastate retail rates. *See* Universal Service Order ¶ 14. Instead, it tinkered with a tiny explicit federal fund and replaced it with a new fund calculated using TELRIC. Thus, while this Court expected that the distortions caused by implicit subsidies would "be phased out," *AT&T Corp.*, 525 U.S. at 394, the FCC has declined to implement the Act in that fashion.

The adverse effect of the FCC's radically discounted TELRIC prices, aggravated by the FCC's blanket unbundling of UNEs, was predictable. Subsidized access to the incumbent's network provided a powerful distorting incentive for entrants to rely on UNEs and at the same time devalued investments some entrants had started to make in facilities of their own. As a result, many entrants rapidly changed their plans away from deploying competing facilities.[9]

In New York alone, for example, by the end of calendar year 2000, competitors using Verizon's UNEs were serving 1.8

[9] MFS, for example, a competitive access provider that already had facilities deployed in many urban centers, quickly announced plans to "re-orient[] its network build-out focus away from building to end-users and instead . . . [to] connect[ing] to the customer via incumbent local exchange carrier unbundled loops." Merrill Lynch, MFS Communications at 2 (Nov. 7, 1996). And AT&T touted the UNE platform to investors as "another way to resell" that would give AT&T a "52 percent" discount below retail rates – more than two to three times the discounts set according to the statutory standards for wholesale services. Transcript, "AT&T Investment Community Meeting" at 5 (Mar. 3, 1997) (J.A. 469). *See also* John J. Keller, *Ringing Bell: AT&T's New President Is Wasting No Time in Shaking Things Up*, Wall St. J., Dec. 24, 1996, at A1 (explaining that AT&T canceled plans to build facilities and elected instead to purchase elements and services from incumbents).

million customers and had eclipsed facilities-based competitors. The losses imposed by TELRIC pricing for those UNEs are massive. While the average historical cost for a copper loop is $33.20 per month, the average TELRIC price for a loop is $14.52 – a discount of over 56%.[10]

In addition, implementing TELRIC pricing for UNEs while implicit subsidies remain embedded in retail rates created further foreseeable problems. *First*, entrants focused on cherry-picking high-margin urban and business customers,[11] and thereby diverted into their own coffers the revenues designed to support universal service. *Second*, because retail rates for residential customers remained below cost, competition for residential customers developed more slowly than it should have. Ironically, these below-cost retail price ceilings have led to further political pressure to reduce UNE prices even more as entrants claim that they cannot compete for residential customers unless deeper discounts enable them to match incumbents' state-imposed, below-cost retail rates. *See, e.g.*, C. Michael Armstrong, *Break Up the Baby Bells!*, Wall St. J., Mar. 28, 2001, at A22 (complaining that "Verizon's 'wholesale' price in New Jersey is twice the amount that retail customers pay").

D. Judicial Review

In their initial challenge to the Local Competition Order, incumbents argued primarily (i) that the FCC's unbundling rules providing blanket access to incumbents' networks

[10] *See Proceeding on Motion of the Comm'n To Examine N.Y. Tel. Co.'s Rates for Unbundled Network Elements*, N.Y. Pub. Serv. Comm'n Case No. 98-C-1357, Hearing Ex. 323, Part A-1, Section 5, at 1.

[11] *See, e.g., Hearing Before the Antitrust Subcomm. of the Senate Judiciary Comm.*, 1999 WL 8084924 (Feb. 25, 1999) (statement of Joel I. Klein, Assistant Att'y Gen., Antitrust Div., U.S. Dep't of Justice) ("These new entrants typically, and naturally, set their sights first on urban business customers as the most profitable slice of the local exchange market . . . .").

violated the terms and purposes of the Act; (ii) that the FCC lacked statutory authority to issue rules governing the Act's pricing provisions at all; and (iii) that the FCC's pricing rules – particularly TELRIC – were unlawful. The Eighth Circuit rejected incumbents' challenge to the FCC's approach to blanket unbundling. It agreed, however, that the FCC lacked jurisdiction over pricing and therefore did not address the incumbents' substantive challenges to TELRIC. *See Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997).

In *AT&T Corp. v. Iowa Utilities Board*, 525 U.S. 366 (1999), this Court agreed with incumbents that the FCC had violated the Act by failing to impose any meaningful restriction on access to network elements. The Act required the FCC "to apply *some* limiting standard, rationally related to the goals of the Act, which it has simply failed to do." *Id.* at 388. The Court therefore vacated the FCC's "primary unbundling rule" and remanded to the FCC. *Id.* at 375.[12]

In *AT&T Corp.*, this Court also reversed the Eighth Circuit's ruling on jurisdiction over pricing and remanded for the Eighth Circuit to address substantive challenges to TELRIC. On remand, the Eighth Circuit rejected incumbents' argument that the pricing standard in the Act required that network-element prices be based on the actual, historical costs of the incumbent's existing network. The court declared the term "cost" ambiguous and deferred entirely to the FCC's decision to base prices solely on forward-looking costs. *See* Pet. App.

[12] On remand, the FCC produced a new rule that actually *expanded* access to network elements even further. *See In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, Third Report & Order and Fourth Further Notice of Proposed Rulemaking, 15 F.C.C.R. 3696 (Nov. 5, 1999). When incumbent carriers sought judicial review, the FCC succeeded in having the case held in abeyance on the ground that it intended to reconsider some aspects of the order. The agency has now been "reconsidering" the order ever since 1999, while incumbents' challenges go unheard.

10a-14a (citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984)). Although the court acknowledged that incumbents had argued for a construction of the Act that would hew to constitutional standards, it applied the wrong standard to incumbents' claim as it concluded that petitioners' "takings claim is not ripe for review." *Id.* at 17a.

Incumbents also argued that, even if the Act would permit a forward-looking cost methodology, it required UNE prices to be based on the forward-looking costs actual firms would incur, not on an unattainable fantasy. The Eighth Circuit agreed and explained that the Act demanded prices based on the actual cost of providing elements to competitors, "not on the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute." *Id.* at 8a. In setting the pricing standards of section 252(d)(1), "Congress was dealing with reality, not fantasizing about what might be." *Id.* at 9a.

SUMMARY OF ARGUMENT

1. The plain text, structure, and purpose of section 252 make it clear that prices must include historical costs. Section 252(d)(1) requires rates for network elements that are "based on the cost . . . of providing" the network element and "may include a reasonable profit." The ordinary meaning of the word "cost" is past expenditure, and particularly where the term has been used with precisely that meaning in the field of telephone rate regulation for half a century, there is no basis for applying a different meaning here. Further, the Act's authorization of a "reasonable profit" makes sense only if "cost" refers to historical cost and "profit" refers to a return after full recovery of investment.

2. a. Constitutional considerations also require that the term "cost" be read to mean historical costs. Section 252(d)(1) requires that network-element rates be "just and reasonable," a formulation that this Court has long understood to demand

adherence to constitutional standards of just compensation. Indeed, since the Act effects a taking of property for which network-element rates are to provide the compensation, the pricing standard must be construed to adhere to constitutional norms. *See, e.g., United States v. Security Indus. Bank*, 459 U.S. 70, 78-80 (1982).

b. In *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989), the Court explained that, when a ratemaker undertakes a fundamental shift in rate methodologies, the new methodology must be evaluated to determine whether it continues to provide constitutionally adequate compensation for previous investments, as measured under the old methodology. *See id.* at 312. TELRIC violates the Just Compensation Clause because it represents a fundamental shift in methodology that makes no provision for the recovery of prior prudent investment, but rather is *designed to preclude* such recovery. TELRIC thus constitutes an extreme form of the opportunistic switch in ratemaking methodologies condemned in *Duquesne*. It impermissibly changes the rules of the game after substantial investment has been induced under the prior regulatory regime. *See Eastern Enters. v. Apfel*, 524 U.S. 498, 532-36 (1998); *Kaiser Aetna v. United States*, 444 U.S. 164, 179-80 (1979).

c. While never denying that TELRIC would strand investment, the FCC sought to salvage the methodology by claiming that it would not threaten incumbents' overall "financial integrity." But any effort to dilute the impact of TELRIC by sweeping in revenues from *all* of an incumbent's other operations violates fundamental takings principles. The government cannot take part of a person's property and claim that it need not pay for it fully on the ground that the person has remaining net worth. Rather, when the government takes a portion of a person's property it must pay fully for what it has taken. In a regulatory context, this means that a regulatory system must pay its own way. A regulator cannot make up a

deficiency in its own rates by pointing to competitive revenues, revenues under the control of a different regulator, or any other revenues it is not responsible for generating. *See Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396, 399 (1920); *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930).

The FCC's various suggestions that incumbents' constitutionally based arguments for interpreting the Act are somehow not "ripe" are equally misplaced. TELRIC is a final rule that systematically undercompensates incumbents. It is subject to review *now* for its failure to adhere to the standard of compensation spelled out in section 252(d)(1) of the Act.

d. Because, at a minimum, TELRIC raises serious constitutional questions, the agency must demonstrate a clear congressional mandate for its adoption. *See Solid Waste Agency v. U.S. Army Corps of Eng'rs*, 121 S. Ct. 675, 683 (2001); *NLRB v. Catholic Bishop*, 440 U.S. 490, 506-07 (1979). That standard is not met here. Thus, the FCC's reading of the word "cost" must be rejected. It is the Court's "settled policy to avoid an interpretation of a federal statute that engenders constitutional issues if a reasonable alternative interpretation poses no constitutional question." *Gomez v. United States*, 490 U.S. 858, 864 (1989).

3. Finally, the FCC's adoption of TELRIC is contrary to the purpose of the statute and is arbitrary and capricious. For years, the FCC and other telephone utility regulators have rejected forward-looking replacement cost models as inherently unworkable and unreliable. Rejection of historical cost in favor of the FCC's novel and unwieldy replacement-cost model frustrates the congressional goal of swift implementation of the Act. Finally, the FCC's effort to have prices reflect an imaginary and unattainable level of efficiency undermines incentives for facilities-based competition and short-circuits the very competitive process that Congress intended to set in

motion. *See AT&T Corp.*, 525 U.S. at 424 (Breyer, J., concurring in part and dissenting in part).

ARGUMENT

I. SECTION 252(d)(1) REQUIRES USE OF HISTORICAL COSTS FOR NETWORK-ELEMENT PRICES.

The Act requires that prices for network elements "shall be . . . based on *the cost* . . . of providing the interconnection or network element." 47 U.S.C. § 252(d)(1) (emphasis added). Even assessed in a contextual vacuum, the word "cost" cannot be read to exclude past capital expenditure. The plain, dictionary meaning of the word "cost" includes the entire amount paid for any particular item or service. *See Webster's Third New International Dictionary* 515 (1993) (defining cost as "the amount or equivalent paid or given or charged or engaged to be paid or given for anything bought or taken in barter or for service rendered"); *Black's Law Dictionary* 345 (6th ed. 1990) ("Expense; price. The sum or equivalent expended, paid or charged for something."). Thus, the ordinary understanding of the word "cost" is, by its nature, "historical" – it focuses on all that has been paid to produce a good or service. The concept of "cost" — what was in fact paid for something – is distinct from the concept of "value," which is the price that would be paid on the open market.

More importantly, in the specific context in which the word is used here – telephone utility ratemaking – the term "cost" has been used for more than fifty years to refer to this same concept of past expenditure, or "historical cost." *See* James C. Bonbright *et al.*, *Principles of Public Utility Rates* 211 (2nd ed. 1988) ("[O]riginal, legitimate cost of plant and equipment, with reasonable allowances for interest during construction and for working capital, is the governing basis of calculation."); *see also MCI Communications Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1118 n.52 (7th Cir. 1983) ("cost" is interpreted "in a utility ratemaking setting to refer to the revenues required

to meet all the accounting, historical or embedded costs of the entire utility enterprise" (emphasis omitted)); Hon. Stephen Breyer, *Regulation and Its Reform* 38 (1982) ("[R]egulators almost uniformly assume that a firm's rate base (which determines the allowable profit) equals the book value of its *historical* investment."). Indeed, two years before Congress enacted section 252, the FCC itself reaffirmed, in the context of cable rate regulation, that "[o]riginal cost is the normal, now traditional method used for public utility valuation." *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation*, Report & Order and Further Notice of Proposed Rulemaking, 9 F.C.C.R. 4527, 4555, ¶ 55 (1994).

Where a statute addresses a specialized field and uses a term that has acquired a fixed meaning in that context, the statute must be construed to apply that settled meaning. *See McDermott Int'l, Inc. v. Wilander*, 498 U.S. 337, 342-43 (1991) (construing the undefined statutory term "seaman" to have its established meaning under maritime regulation); *Corning Glass Works v. Brennan*, 417 U.S. 188, 201-02 (1974) (construing the undefined statutory term "working conditions" to have its established meaning under labor regulation). Although the FCC points to the theoretical possibility that the word "cost" can mean different things in *different* contexts, the fact remains that, in the context in which the word is used here, "cost" has had a consistent meaning for decades – *i.e.*, "historical" cost. Given this longstanding usage, it is implausible to conclude that rates "based on the cost" would exclude past capital investment.

Beyond the word "cost" itself, the text and structure of several interrelated provisions of sections 251 and 252 confirm that section 252(d)(1) uses the word "cost" in its usual sense. First, section 252(d)(1)(B) states that the prices for network elements "may include a reasonable profit." A profit cannot be realized absent full recovery of costs, including capital costs.

California Dental Ass'n v. FTC, 526 U.S. 756, 768 (1999) ("[A]ccording to a generally accepted definition 'profit' means gain from business or investment over and above expenditures, or gain made on business or investment where both receipts or payments are taken into account . . . ." (internal quotation marks omitted)). The FCC itself acknowledged that, "in plain English, profit is defined as 'the excess of returns over expenditure in a transaction or a series of transactions.'" J.A. 393 (¶ 699) (citing *Webster's New Collegiate Dictionary* 931 (10th ed. 1994)). Yet the FCC treated return on investment as simply another forward-looking "cost." This left no room for consideration of what constituted a reasonable profit because, in the agency's view, profit was "embodied" in its own definition of cost. *See* J.A. 393-95 (¶ 700). The FCC's reading thus renders irrelevant the entire subsection of the Act addressing "profit," thereby violating a cardinal canon of statutory construction. *See, e.g., Bennett v. Spear*, 520 U.S. 154, 173 (1997); *United States v. Menasche*, 348 U.S. 528, 538 (1955).

The Act's bifurcation of the pricing determination into "cost" and "profit" neatly tracks the two-step process traditionally associated with cost-of-service ratemaking. Historical expenditure constitutes the ratebase, to which a rate of return calibrated to the nature and risk of the industry is applied. The use of the word "reasonable" to modify "profit" supports this view. It has meaning in this context only as a reference to the exercise of discretion by a regulator in setting a rate of return. If "cost" in section 252(d)(1)(A) is read as exclusively "economic cost," the phrase "reasonable profit" in section 252(d)(1)(B) is a non sequitur.

Second, several provisions of the Act make clear that it does not authorize or contemplate a wholesale reexamination of the incumbent carriers' actual costs. The FCC was required to "complete all actions necessary" to implement the local competition provisions, including pricing standards, within six

months of the Act's enactment. *See* 47 U.S.C. § 251(d)(1). Section 252(d)(1) itself expressly forbids the conduct of a traditional ratemaking inquiry: "cost," it directs, shall be "determined without reference to a rate-of-return or other rate-based proceeding." The FCC itself explained that this directive "does not further define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed." J.A. 397-98 (¶ 704). And as the FCC noted, Congress was "eager to set in motion expeditiously the development of local competition" and wished to avoid "the costs and administrative burdens associated with a traditional rate case." *Id.* The strong inference from the congressional desire for swift action and the limitations Congress placed on the procedures to be employed is that "cost" refers to something already established and readily available, *i.e.*, historical cost as documented on incumbents' books. The Act's prohibition of familiar ratemaking procedures in the name of rapid implementation plainly forbids, *a fortiori*, the use of a novel, complex, and difficult-to-administer hypothetical cost model.[13]

The parallel provisions in the Act for determining wholesale prices for *services* to be resold (as opposed to "*elements*") further support the conclusion that "cost" in section 252 includes historical cost. In the resale context, the Act provides for wholesale prices based on retail rates, which Congress noted would continue to permit incumbents to recover

[13] Similarly, because it precludes the traditional procedures associated with the adjustment or reduction of a utility's rate base, the Act necessarily suggests that Congress intended that rates be based on existing cost figures. Any other approach would raise due process concerns. Rudimentary principles of due process would require notice and a right to be heard before incumbents could be denied recovery of prudent capital investments whose recovery had previously been approved by state regulators. *See Ohio Bell Tel. Co. v. Public Utils. Comm'n.*, 301 U.S. 292, 300 (1937); *West v. Chesapeake & Potomac Tel. Co.*, 295 U.S. 662, 675-77 (1935).

historical costs. *See* H.R. Rep. No. 104-204, at 72 (1995). Having preserved the incumbent's opportunity to recover historical costs on the resale of *services*, Congress can hardly be thought to have contemplated the exclusion of all historical costs for the pricing of network *elements*. If Congress was not "fantasizing" about hypothetical costs in the context of pricing services, it is implausible to maintain that it nonetheless authorized a purely hypothetical standard for pricing network elements. *See Gustafson v. Alloyd Co.*, 513 U.S. 561, 569 (1995) (statutes are to be interpreted as part of "a symmetrical and coherent regulatory scheme").

Finally, as discussed below, under *Chevron* step one constitutional considerations constrain the permissible reading of the word "cost" for two reasons: (1) the Act's requirement of "just and reasonable" rates expressly incorporates a constitutional standard; and (2) the doctrine of constitutional avoidance precludes an interpretation that raises serious constitutional questions. *See, e.g.*, *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 n.9 (1984) (court employs all "traditional tools of statutory construction" on first step of *Chevron*); *Solid Waste Agency v. U.S. Army Corps of Eng'rs*, 121 S. Ct. 675, 683-84 (2001) (same).

II. UNDER CONSTITUTIONAL PRINCIPLES, SECTION 252 CANNOT BE CONSTRUED TO AUTHORIZE TELRIC.

Because of what it says and because of what it does, section 252 must be construed to mandate constitutionally sufficient compensation. The Act's command that rates be "just and reasonable" explicitly incorporates the constitutional standard of just compensation. Moreover, because the Act effects a taking of property for which network-element rates are to provide the compensation, the rates must satisfy constitutional norms.

The FCC has fundamentally shifted rate methodologies in midstream so as to preclude incumbents from recovering their embedded costs – that is, past prudent investment made in reliance on the prior regulatory regime. The FCC's action is precisely the kind of opportunistic switch this Court condemned in *Duquesne*. Because TELRIC violates the Constitution, it violates the Act.

A. Section 252 Mandates a Pricing Methodology Designed To Provide Constitutional Compensation.

In requiring that rates be "just and reasonable," section 252(d)(1) incorporates the Fifth Amendment's guarantee of just compensation and thus expressly commands that any rate methodology be designed to produce the full measure of compensation due under the Constitution. The phrase "just and reasonable" is a term of art that has long been construed to require compensation that meets constitutional standards. *See, e.g., In re Permian Basin Area Rate Cases*, 390 U.S. 747, 769-70 (1968); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

Section 252 is a classic utility rate regulation scheme. It forces a dedication of property, it directs compensation through just and reasonable rates, and it designates a class of users required to pay the compensation through those rates. Thus, the overarching purpose of section 252 is *compensatory*. Its core command – as with any utility ratemaking regime – is not only that incumbents should receive full compensation, but also that they should receive full compensation *through the rates*. The very objective of a utility ratemaking regime is to avoid future government liability for an uncompensated taking by requiring the regulator to design rates that will fully compensate the utility. Such a regime ensures that the utility is fully compensated, that the liability for compensation is borne by a designated class of private users (not by the public treasury), and that investors' expectations are settled by a predictable mechanism that informs investors in advance how they will be paid.

The Fifth Amendment is implicated in this case because, under the 1996 Act and the FCC's implementing regulations, incumbents are being compelled to turn over parts of their networks for their competitors' exclusive use. *See* J.A. 285-86 (¶ 268) (an entrant purchasing "access to an unbundled network facility is entitled to exclusive use of that facility for a period of time"). The Act thus accomplishes a taking that demands constitutionally adequate compensation. Where a utility is compelled to dedicate its property to public use, the government must provide the utility the full compensation due under the Constitution. *See, e.g., Duquesne*, 488 U.S. at 307-08.

It is because of this imperative for just compensation that utility statutes, like the one here, are often explicit in demanding "just and reasonable" rates. But even in the absence of such specific direction, this statute would have to be construed to provide compensation that meets the constitutional minimum. Where Congress conscripts private property for public use and establishes a mechanism for compensation, the strong presumption must be that Congress intends the mechanism itself to provide the full measure of compensation due under the Constitution. *See, e.g., Phelps v. United States*, 274 U.S. 341, 344 (1927). And especially in the utility context where the statute not only effects a taking but also prescribes a class of persons to pay, the rates must provide constitutional compensation. An agency cannot be permitted to create unintended liability for the Treasury by construing the statute in a manner that would result in an uncompensated taking of property. *See Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441, 1445 (D.C. Cir. 1994).

For these reasons, the Constitution constrains any construction of the word "cost" in section 252(d)(1). That term *must* be construed to preserve the opportunity for incumbents to recover all costs they are entitled to recover under the Constitution. An agency interpretation of that term that fails to provide for such recovery violates the statute and the constitutional standard that it incorporates. Moreover, the agency's interpretation of what costs the Constitution requires

to be recovered is not entitled to deference under *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). This is so not only because an agency's interpretation of constitutional requirements generally is not entitled to deference, *see infra* pp. 42-44, but also because the judiciary, not the political branches, has the exclusive province to determine what just compensation requires. *See, e.g.*, *Monongahela Navigation Co. v. United States*, 148 U.S. 312, 327 (1893) ("It does not rest with the public, taking the property, through congress or the legislature, its representative, to say what compensation shall be paid, or even what shall be the rule of compensation.").

B. TELRIC Violates Section 252(d)(1) Because It Shifts Methodologies Without Providing for Recovery of Past Prudent Investment.

In its Local Competition Order, the FCC made a profound change in the measure of costs incumbents are permitted to recover. It abandoned the longstanding regime under which incumbents were given the opportunity to recover their actual investment and moved to an extreme version of replacement costs. This fundamental shift in methodologies necessarily raises the question whether the new methodology is sufficient to provide a constitutionally adequate return with respect to investments made under the prior regime. The principles established by this Court in *Duquesne* provide the template for evaluating such shifts.

At the inception of a regulatory regime, when investors first choose to dedicate their property to public use, a regulator has some flexibility in choosing a methodology for determining compensation. Any of several methods, including an historical cost method or a reproduction-cost method, could satisfy constitutional requirements. *See Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). Once the government has selected a methodology and induced substantial investment under that regime, however, the government's ability to *switch* methodologies is necessarily constrained.

After the government has induced private investment that has produced valuable property under one set of regulatory rules, there will often be a strong temptation to use government power to appropriate some or all of that value to the benefit of the public at reduced cost. Changing rate methods in midstream can accomplish precisely such an appropriation of value by effectively foreclosing recovery of a constitutional return on the very investments that were made in reliance on the original method. No less than in other instances of expropriation of private property, the Fifth Amendment precludes the government from inducing substantial investment in reliance upon one set of rules and then reaping the rewards of that investment by unilaterally altering the rules of the game. The Constitution thus does not preclude all changes in methodology. What it *does* preclude is a switch in methodologies unaccompanied by some mechanism to compensate for investment stranded by the shift in methodologies itself. This is simply a specific application of the bedrock principle that "a strong public desire to improve the public condition is not enough to warrant achieving the desire by a shorter cut than the constitutional way of paying for the change." *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 416 (1922) (Holmes, J.).

In *Duquesne*, the Court applied this principle in evaluating a shift in ratemaking methodologies. *Duquesne* involved a "sligh[t] modifi[cation]" of the rate method within the context of an historical cost system. 488 U.S. at 310. Rather than allowing some recovery of investments that, although prudent when made, had not proved "used and useful," the new method eliminated any recovery for such investments. *Id.* at 304-05, 310 n.7. The Court evaluated whether this slight change raised constitutional difficulties by determining whether the shift adversely affected investors' opportunity to recover all their previous prudent investment and an appropriate rate of return under the old methodology. The Court determined that the new method was still projected to produce recovery that was "within the constitutional range of reasonableness" *as measured under the old methodology*. *Id.* at 312. Under *Duquesne*, in other

words, the new system must still provide for recovery of the investments made under the prior system *and* a return on that investment that would have been constitutionally sufficient under the old system. Indeed, in concurrence, Justice Scalia, joined by Justices White and O'Connor, observed that, for courts to determine whether a rate methodology provided a constitutionally adequate "fair return," "all prudently incurred investment may well have to be counted." *Id.* at 317.

The FCC's newly minted TELRIC methodology plainly fails the *Duquesne* test. *Duquesne* involved a slight modification within the context of an historical cost rate method. Here, in contrast, TELRIC jettisons historical costs altogether in favor of an extreme version of replacement costs. The FCC fully understood that TELRIC rates would be below historical costs and would not allow recovery of those costs. That was the intent of TELRIC, *see supra* p. 9, and, given the assumptions built into the methodology, its inexorable effect. TELRIC thus, *by design*, falls short of satisfying the constitutional test applied in *Duquesne*. The FCC never disputed that TELRIC would strand investment on UNEs. Nor could it do so. The FCC itself set "proxy prices" to approximate TELRIC and produced forward-looking costs that are roughly 60% below historical costs. *See supra* p. 10. With a stroke of the pen, the FCC thus redefined as "unrecoverable" half the costs that incumbents have incurred in establishing and maintaining the networks that now must be sold off piecemeal to new entrants.

As if forewarning against the FCC's conduct here, the *Duquesne* Court contrasted the slight shift in that case with changes that more fundamentally alter risks. *See* 488 U.S. at 312 n.7, 315. The Court admonished against shifts that would allow the government opportunistically to reap the benefits of investments without paying for them: "[A] State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise *serious constitutional questions*." *Id.* at 315 (emphasis added).

The FCC's abrupt shift to TELRIC is precisely the sort of fundamental and opportunistic switch condemned in *Duquesne*. For decades, regulators have reaped the benefits of the historical cost method, which worked to the government's advantage as long as asset values were stable or rising. By promising investors a fair opportunity to recover all capital prudently invested and insulating them from the risk of asset value fluctuation, regulators could insist on lower rates of return and extended depreciation schedules. Because they did not have to compensate investors for the risk that their investments would suffer fluctuations in market value, regulators could keep consumers' rates low and stable. For their part, investors were never allowed to profit when the value of the network was increasing. Returns were based on capital investment. Most importantly, for all the investment sunk under the prior regime, investors have never been compensated for the risk that recovery would be based on the vagaries of fluctuations in asset value.

The FCC has used the Act as an opportunity to conjure up a hypothetical world where replacement costs are substantially below book value. And it has used its newfound regulatory authority to impose that extreme version of a replacement-cost methodology on incumbents – a shift it seeks to make without ever having paid investors for the risk of such a shift and without providing for the investment that will be stranded as a result.

The FCC's bait-and-switch is particularly egregious here, moreover, because the regulators' own decisions have magnified the amount that will be stranded by the shift. One of the ways regulators promoted universal service under the prior system, for example, was artificially prolonging depreciation lives to push off recovery of costs into the future. *See supra* p. 4. That meant that incumbents carried accounts reflecting undepreciated investments in assets, even though those accounts no longer corresponded to the economic value of the assets. Switching to TELRIC abruptly cuts off recovery of those amounts, even though recovery had been promised as a critical component of the past system.

The harsh retroactivity of the FCC's about-face is patent. The switch effectively reaches back and recharacterizes the legal effect of an incumbent's actions by recategorizing investments that were prudent (and therefore could be recovered) as now unrecoverable – long after the investments were made. TELRIC thus has the effect of rewriting the terms of thousands of regulatory transactions closed long ago. *See Eastern Enters. v. Apfel*, 524 U.S. 498, 532-36 (1998); *see also id.* at 548 (Kennedy, J., concurring) ("If retroactive laws change the legal consequences of transactions long closed, the change can destroy the reasonable certainty and security which are the very objects of property ownership."). It accomplishes that result by suddenly exposing the utility to a regulatory risk – repricing based on the unattainable efficiencies of an imaginary carrier – that was never accounted for in the original method for determining compensation. The effect is to wipe out a significant portion of the recovery on past investments that had always been counted on as a necessary component for supplying a constitutional return under the old regime.

Investors never would have agreed to invest the huge sums necessary to construct a telephone network if, rather than offering a stable opportunity to recover all prudent investments, the government had instead reserved the right to eliminate any opportunity to recover investments upon a whim. In this instance no less than in others, the Court must look with extreme skepticism on government action that would eliminate the basis on which private parties have relied in making substantial investments. *See, e.g., Kaiser Aetna v. United States*, 444 U.S. 164, 179-80 (1979) (government consent to plan to dredge pond created "expectancies" amounting to a property interest that the government could not later frustrate by declaring pond a navigable waterway open to public without paying just compensation); *cf. United States v. Winstar Corp.*, 518 U.S. 839, 863-64 (1996) (plurality opinion); *id.* at 913 (Breyer, J., concurring) (government adherence to contractual obligations is necessary to induce private parties to "undertake the risk of government contracting").

Duquesne simply recognizes that, where the government has invited reliance on its regulatory system to induce investment, it cannot fundamentally alter the rules with impunity. TELRIC violates *Duquesne* because it changes rate methodologies without providing any mechanism to preserve incumbents' opportunity to recover prior investments made in reliance on the historical cost regime.

C. The FCC's Efforts To Deflect Scrutiny from the Constitutional Defects in TELRIC Are Meritless.

Throughout the rulemaking proceeding the FCC peremptorily dismissed the "serious constitutional questions" identified in *Duquesne*. Incumbents repeatedly insisted that they were entitled to an opportunity to recover their embedded costs and proposed numerous alternative mechanisms that would have at least preserved the opportunity to recover embedded costs that were not recoverable through TELRIC rates. *See* J.A. 398-99, 399-400 (¶¶ 705, 706). The FCC responded that, "[e]ven if the incumbent LECs' contention is correct," *id.* at 399-400 (¶ 706), setting rates to allow recovery of embedded costs stranded by TELRIC would "interfere" with its policy goals of managing competition to optimize "efficient" entry. *See id.* But the FCC's policy predilections cannot excuse its failure to comply with the dictates of the statute and the Constitution.

The FCC conclusorily asserted that the amount of investment stranded by TELRIC would not "necessarily" be "significant." *Id.* at 400-01 (¶ 707). But the FCC's statutory and constitutional duty was to ensure that incumbents were fully compensated for the newly established UNE wholesale business. Prices for network elements must reflect the "cost" of the elements, not some lesser portion of the cost based on the agency's unexplained pronouncement that the difference is not "significant." The FCC cannot deny that TELRIC prices are half the historical costs of UNEs and therefore require incumbents to operate the entire wholesale enterprise at a substantial loss. In addition, as explained more fully below, the significance of the losses caused by TELRIC cannot be watered

down by looking at the company's overall financial position. *See infra* pp. 32-37.

Ultimately, the FCC has advanced two legal arguments to justify its failure to make any provision for the recovery of past investment. The first argument – advanced in the Order itself – is that, although the UNE rates will not in themselves allow recovery of historical investment, they are not confiscatory because incumbents have not shown that their overall "financial integrity" would be impaired. J.A. 420-22 (¶¶ 736-738). The second argument – advanced in litigation and embraced by the court below – is that incumbents' arguments are somehow not "ripe." Both lines of argument are fallacious.

1. Under the "total effect" test, TELRIC's deficiencies cannot be cured by looking to revenues earned from *all* of an incumbent's operations.

The FCC seeks to deflect the charge that TELRIC rates are confiscatory by claiming that the rates need not provide constitutionally sufficient recovery in themselves. Instead, in its Order, the FCC distorted the *Duquesne* "total effect" test by claiming that it could look to *all* of an incumbent's overall revenues to make up for any deficiency in TELRIC rates. It thus concluded that TELRIC rates would not be confiscatory because unspecified "revenues from other services" might make up any shortfall, J.A. 421 (¶ 737), and because incumbents had not proven that their overall "financial integrity" would be impaired, *id.* at 421-22 (¶ 738). The FCC's conclusion that it can compel an incumbent to sell UNEs at noncompensatory rates, so long as the firm as a whole remains profitable, violates the most basic tenets of the Just Compensation Clause as well as section 252's command that UNE rates be "just and reasonable."

It is axiomatic that, when the government takes some portion of a person's property, it must pay in full for the part it has taken. The government cannot take property from a person and evade compensation on the ground that the person still has remaining net worth or, in the case of a corporation, a

profitable bottom line. Thus, the government could not compel General Motors to sell Chevrolets below cost simply because, due to earnings on Cadillacs and Buicks, the company as a whole remained profitable.

This principle applies with full force where, as here, an agency has ratemaking power over *part* of a firm's overall business. This Court long ago recognized that, where a regulator controls revenues in only a segment of a firm's overall business, it must allow the particular enterprise over which it has control to make a sufficient return to stand on its own. The regulator may not force the enterprise it is regulating to operate at a loss and claim that the deficiency can be covered by other parts of the firm's business whose revenues the regulator is not responsible for generating. Thus, in *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396, 399 (1920), the seminal case applying this principle, this Court held that regulators could not justify below-cost railway rates by claiming that the railroad was still profitable due to healthy returns in its competitive lumber business.

The principle underlying *Brooks-Scanlon* is that a regulator may not set below-cost rates in one line of business and claim that the deficiency is offset by revenues from a different line of business unless it can legitimately claim responsibility for generating those off-setting revenues – as, for example, where the regulator has used its power to enable an off-setting supracompetitive return. Thus, as the *Brooks-Scanlon* Court recognized, a regulator cannot take credit for revenues earned in a competitive market because it is not responsible for those revenues and they represent the return due the firm for risking capital in the competitive enterprise. As Justice Holmes explained, earnings from competitive operations are the firm's private property, and a firm "no more can be compelled to spend that [money] than it can be compelled to spend any other money to maintain a railroad for the benefit of others who do not care to pay for it." *Id.*

The same underlying principle is reflected in the rule that a regulator may not justify deficient rates by pointing to revenues

from operations under a different sovereign's jurisdiction. *See, e.g.*, *Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930); *Chicago, M. & St. P. Ry. v. Public Utils. Comm'n*, 274 U.S. 344, 350-51 (1927). The first regulator cannot claim that its action enabled the firm to earn those revenues and thus cannot claim credit for them as a "payment" to compensate for any shortfalls in rates it has imposed. Those revenues are already spoken for: the *other* sovereign has determined that they are necessary to compensate the utility for the business conducted under *its* jurisdiction.

The "total effect" test from *Duquesne* is fully consistent with these principles. Contrary to the FCC's assertion, that test does not give a regulator license to rely on revenues outside its control to cure a deficiency in the rates it has set for a regulated service. Rather, the "total effect" test focuses solely on *those revenues the regulator has control over and is responsible for generating*. It simply provides that, where a regulator has control over multiple services of a firm, it may set the rate for one service below cost so long as it compensates for the shortfall by using its regulatory power to enable an offsetting extra return on another product. Thus, where a regulator uses its regulatory power to restrict competitive entry, it can legitimately claim credit for the off-setting revenue because it has enabled the supracompetitive return. In short, the test simply recognizes that a regulator may create cross-subsidies *within* the range of services under its regulatory control. It is in this context that this Court has said that subsidiary puts-and-takes in a rate order are not of constitutional dimension, as long as the regulator has set rates in the aggregate to provide a sufficient return on the regulated part of the business under its control. *See Duquesne*, 488 U.S. at 310, 314.

In *Hope* and *Duquesne*, the company at issue was a regulated monopoly in *all* its operations. In those cases, therefore, it was proper to consider the company's overall revenue from all operations in determining the sufficiency of a rate order. But those cases clearly do not mean that, where a regulator's control is limited to part of a business, that regulator can justify a non-compensatory rate on a regulated service by claiming that

revenues from sources outside its control make up the difference. Thus, the core principle under the total effect test is that the regulator can claim credit only for revenues that are under its control and that it is in fact responsible for generating through restrictions on competition or other uses of its regulatory power.[14]

Thus, the FCC's duty – both under the foregoing principles and the express directive of section 252 – was to set UNE rates that would allow the UNE business to generate a sufficient return to stand on its own. The Act established a new UNE wholesale business, and section 252's command that rates be "just and reasonable" and "based on the cost . . . of providing" the UNE was directed specifically at ensuring that UNE rates fully covered the costs of that business. Congress thus intended that the costs of UNEs be reflected in UNE prices – not in the prices for other services. For ratemaking purposes, therefore, the FCC was required to treat the UNE business as a discrete enterprise and set rates sufficient to allow that enterprise to pay for itself. Apart from this statutory obligation, the principles underlying *Brooks-Scanlon* prohibited the FCC from justifying deficient UNE rates by pointing to other revenues that it could claim no credit for generating. In any event, looking to revenues from any other source to make up for deficient UNE rates would mean creating a new cross-subsidy in rates, an approach that runs flatly counter to the express congressional directives elsewhere in the Act to ensure that implicit subsidies are eliminated. *See, e.g.*, 47 U.S.C. § 254(d), (e); *see also*

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[14] The Supreme Court of California applied this principle to strike down a statutory test for determining the adequacy of insurance rates where the test "refer[red] to the financial position of the company as a whole, not merely to the regulated lines of insurance." *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247, 1254 (Cal. 1989). The court explained: "If an insurer had substantial net worth, or significant income from sources unregulated by [this statute], it might be able to sustain substantial and continuing losses on regulated insurance without danger of insolvency. In such a case the continued solvency of the insurer could not suffice to demonstrate that the regulated rate constitutes a fair return." *Id.*

AT&T Corp., 525 U.S. at 393-94 (section 254 "requires that [implicit] universal-service subsidies be phased out").

The FCC's reasoning in paragraphs 736-738 of the Order flatly contravenes these basic precepts. Incumbents are engaged in numerous businesses over which the FCC has no ratemaking authority. These include businesses that have long been competitive, such as wireless service and yellow pages, as well as the traditional retail local telephone business, now open to competition and still under state regulatory jurisdiction. It is plainly impermissible for the FCC to claim that revenues from any of these businesses can be counted to offset deficient UNE rates. Indeed, the FCC expressly acknowledged that, in evaluating the adequacy of TELRIC rates, it could consider solely revenues under its jurisdiction. *See* J.A. 421 (¶ 737 n.1756). While vaguely suggesting that "revenues for other services under [its] jurisdiction" might be counted, *id.* at 421 (¶ 737), the FCC never identified which revenues those were, nor could it do so.[15]

In the very next paragraph, the FCC did a complete about-face. Having just acknowledged that it could look only to revenues under its jurisdiction, the FCC concluded that TELRIC rates are sufficient because incumbents have not shown that their overall "financial integrity" will be impaired. By using that standard, the FCC failed to limit its inquiry to revenues for which it was responsible and instead sought to conscript *all* of an incumbent's revenues to cure the obvious inadequacy of TELRIC rates. This is plainly impermissible.

[15] The primary sources of revenue regulated by the FCC are interstate access charges and interstate long distance rates. But access charges are set to compensate incumbents for the cost of transporting interstate traffic over their local networks. While the FCC has at times suggested that it might consider adjustments to access charges to address stranded historical costs, *see* Universal Service Order ¶ 230 n.593, it has never raised those charges to compensate for below-cost UNE rates. Instead, it simply avoided the issue in its Access Charge Reform Order. *See supra* p. 12. As for revenues from incumbent LECs' nascent entry into interstate long distance markets, those markets are highly competitive and thus also provide no source of revenues for the FCC to count.

The FCC thus failed to conduct the inquiry demanded by *Duquesne* – whether TELRIC rates for UNEs will preserve incumbents' opportunity to recover their past prudent investment. It sidestepped the issue by applying an improper standard – whether TELRIC rates are so disastrously deficient that they will drag an incumbent's entire enterprise into financial jeopardy.

2. TELRIC must be evaluated now as a final agency action that is contrary to the Act.

The FCC's second effort to avoid any scrutiny of TELRIC conflates several distinct concepts. The FCC contended below, and the Eighth Circuit held, that petitioners' constitutionally based arguments are somehow not "ripe"; that TELRIC cannot be evaluated against constitutional standards now because it is impossible to challenge a rate methodology; and that petitioners' claims concerning inherent constitutional defects in TELRIC should instead be addressed in dozens (or hundreds) of federal district court actions on review of individual arbitrations under section 252(e)(6) of the Act. None of these contentions can withstand scrutiny.

First, assertions that incumbents' "takings claim" is not "ripe" are wholly out of place. In this case, petitioners have not brought a takings claim seeking compensation. Instead, this action is a petition for review, pursuant to the Administrative Procedure Act, seeking an evaluation of whether the FCC has acted unlawfully by promulgating a rule that violates the 1996 Act. The relief petitioners seek is correction of the FCC's pricing methodology so that it carries forth Congress' intent to provide for recovery of embedded costs through the rates paid by third-party users. This is thus a challenge to final agency action, and the petition for review and the constitutional arguments that underpin it are indisputably ripe for consideration. It is quintessentially the role of this Court to review claims that the agency is not properly implementing its enabling statute.

Second, to the extent the FCC's blanket assertions that courts "cannot review a methodology" are meant to suggest that only

specific sets of rates can be reviewed and that an underlying methodology is immune from review, that is plainly not the law. An agency's selection of a rate methodology is subject to judicial review – and has always been reviewed – in the same way as other final agency actions: for compliance with the governing statute and requirements of reasoned decisionmaking. Ratemaking is by its nature a teleological process by which the ratemaker must define the target at the outset – what costs are required to be recovered under the statute – and then must develop a methodology reasonably aimed at achieving that recovery. In other words, ratemaking requires a regulator to define the acceptable outcome in advance and to choose a method designed to achieve that end. And the agency must determine whether the *projected* outcome of its methodology meets the statutorily prescribed objective. *See Permian Basin*, 390 U.S. at 792; J.A. 420-21 (¶ 736) (acknowledging that, in adopting TELRIC, FCC must "consider whether the end result of incumbent LEC rates is just and reasonable"). This requirement is but a specific application of the broader principle that, when it takes property, the government must make a "reasonable, certain, and adequate provision for obtaining compensation *at the time of the taking*." *Presault v. ICC*, 494 U.S. 1, 11 (1990) (emphasis added) (internal quotation marks omitted).

This Court has repeatedly entertained challenges to rate methodologies at the time of their promulgation to determine whether they were rationally designed and projected to provide a constitutionally adequate return. In *Duquesne*, for example, the Court examined the effect that a new rate method "will" have. 488 U.S. at 312; *accord Hope Natural Gas*, 320 U.S. at 603-05; *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 596-98 (1942); *West v. Chesapeake & Potomac Tel. Co.*, 295 U.S. 662, 675-77 (1935); *see also Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1178 (D.C. Cir. 1987) (en banc) (under "total effect" test, a court must determine whether a "rate order may reasonably be *expected* to

maintain financial integrity and attract necessary capital") (emphasis added) (internal quotation marks omitted).[16]

Thus, where, as here, a methodology is not designed to achieve an acceptable outcome, a firm is not relegated solely to piecemeal attacks on specific rates resulting from the defective methodology. Rather, the firm may challenge the defective methodology itself. Were it otherwise, no methodology the agency put in place – no matter how deliberately non-compensatory or capricious – could be challenged. The agency could set compensation by spinning a roulette wheel each year, and the utility would be limited to annual challenges to the results produced by the roulette wheel.[17]

Here, as outlined above, the Act must be read, in light of *Duquesne*, to provide for recovery of embedded costs. TELRIC is expressly designed to *preclude* that recovery. Nothing more is required for the Court to be able to determine now that TELRIC does not comply with the Act.

At times, the FCC's vague claims about "ripeness" seem intended to suggest that TELRIC cannot be evaluated now because it is somehow uncertain whether TELRIC will produce figures higher or lower than historical costs. That is nonsense.

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[16] The FCC would turn these precedents on their head. Pointing to the fact that the courts in some of these cases found the methodological errors inconsequential, the FCC leaps to the grand claim that *no* methodology may ever be reviewed. That misses the point: first, the courts *were* reviewing the methodology in those cases, and second, where they found subsidiary mistakes inconsequential it was *precisely because* they could determine that the methodologies, despite any possible errors, were still aimed at and were projected to achieve an acceptable outcome. The Court has never suggested that a methodology is immune from review when it is *designed* to produce inadequate results.

[17] Indeed, the FCC's wait-and-see mantra begs the question: When is the "end result" arrived at that makes it possible to evaluate the impact of a methodology? Apparently, in the FCC's view, it is arrived at when the continuing losses mount to the magnitude that they impair the overall financial integrity of the company. In other words, the FCC's vague ripeness claims are merely a repackaging of its erroneous contention that the government can take incumbents' property without compensation for as long as incumbents remain financially viable overall.

The FCC adopted TELRIC with the *express purpose* of producing prices lower than historical costs, *see supra* p. 9, and applications of TELRIC both in the FCC's own proxy prices and in state arbitrations have produced massive discounts below historical costs, *see supra* pp. 10-11. In any event, feigned agnosticism concerning the outcome TELRIC will produce relative to historical costs, far from providing a reason to hold judicial review at bay, only highlights another FCC error. As explained above, an agency charged with ensuring "just and reasonable" rates has a duty to establish a methodology *designed* to produce constitutional compensation. The FCC cannot avoid its duties by suggesting that, though not designed to do so, TELRIC *might* serendipitously end up covering incumbents' historical costs in the end. That is the antithesis of the project Congress demanded. Section 252(d)(1) requires reasoned decisionmaking, not agnosticism. It requires shooting at a defined target, not shooting in the dark.

Third, the FCC has also suggested that judicial review must wait because, even though the FCC has cut the rate base in half by precluding consideration of historical costs, States in individual arbitrations might somehow set rates of return at sufficiently supranormal levels that prices will ultimately cover historical costs anyway. Thus, the FCC has argued that incumbents must wait to challenge specific rate determinations as they arise from individual arbitrations. But the rates that TELRIC will produce are necessarily unlawful because the FCC's Order expressly *foreclosed* the States from addressing and rectifying the core defects in TELRIC. The FCC prohibited setting rates of return with a view to allowing historical cost recovery. *See* 47 C.F.R. § 51.505(d)(1). Indeed, the agency repeatedly stated that setting UNE rates to cover historical costs would interfere with the FCC's policy objectives. *See* J.A. 398-400 (¶¶ 705-706). The FCC's order, moreover, requires the States to start with the existing rate of return, and places the burden on incumbents to demonstrate with specificity that the business risks – defined exclusively in terms of facilities-based entry by competitors – justify any change in the rate of return. *See* J.A. 395-96 (¶ 702). In short,

the FCC sharply cabined the States' discretion to ensure that they would not adjust the rate of return to produce rates sufficient to cover historical costs, or otherwise to ensure that the overall effect of the rates is compensatory. Correction of the FCC's methodological errors by the States would thus be impossible.

Because state commissions cannot correct the central defect in TELRIC, district court actions under section 252(e)(6) to review individual arbitrations are simply not a mechanism for addressing incumbents' claims. Indeed, the notion that incumbents' claims can be shunted off to section 252(e)(6) cases suffers from a further defect. The district court's primary role in a section 252(e)(6) case is reviewing a state arbitration for compliance with the Act as interpreted by the FCC, not entertaining challenges to the FCC's directives. In fact, the government has argued that, if FCC rules are not struck down on direct review, they "are no longer subject to further challenge in district court proceedings under section 252(e)(6)," Br. for FCC & U.S. at 40 n.14, *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) (No. 97-831), and at least one court of appeals has agreed, *see GTE South Inc. v. Morrison*, 199 F.3d 733, 742-43 (4th Cir. 1999).

In addition, it is ironic that the FCC would now hold out the possibility of state-by-state jiggering of the rate of return as the cure-all for TELRIC. The suggestion that individual States, while barred from explicitly considering historical costs, might nonetheless jury-rig some adjustments to come up with numbers that cover those costs in the end plainly cannot salvage TELRIC as a product of reasoned decisionmaking by the FCC. The FCC, moreover, previously insisted before this Court that the Act required nationally uniform implementation and that the sort of state-to-state variation it is now touting would lead only to "anticompetitive uncertainties that would impair effective implementation" of the Act. Br. for FCC & U.S., *supra*, at 41. Indeed, the FCC criticized the "protracted and piecemeal litigation" of section 252(e)(6) actions – which it now offers as the only avenue for incumbents to raise their claims – as a wholly inadequate mechanism for addressing

"fundamental disputes about the core provisions of the 1996 Act." *Id.* at 16.

D. Section 252(d)(1) Should Be Construed To Avoid the Serious Constitutional Questions TELRIC Raises.

The Court need not decide that TELRIC violates the Constitution to grant the petitions for review. Statutes must be interpreted not only to avoid constitutional *violations*, but also to avoid the need to reach *serious constitutional questions*. It is the Court's "settled policy to avoid an interpretation of a federal statute that engenders constitutional issues if a reasonable alternative interpretation poses no constitutional question." *Gomez v. United States*, 490 U.S. 858, 864 (1989); *see also Legal Servs. Corp. v. Velazquez*, 121 S. Ct. 1043, 1050 (2001); *Ashwander v. Tennessee Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring).

This principle of judicial restraint decides this case. Petitioners maintain that the Act requires using historical costs for network-element prices. *See supra* pp. 19-31. It is indisputable that an interpretation of the word "cost" in section 252(d)(1) that includes historical costs is at least one *permissible* reading of the statute. It is also undisputed that network-element prices that recover historical costs and a reasonable return are beyond constitutional reproach.

On the other side of the equation, in TELRIC the government has "switched" ratemaking methodologies in a manner that will necessarily preclude recovery of significant amounts of prudent capital investment. In *Duquesne*, this Court described such a radical shift in valuation methods in the very language used by the *Ashwander* line of cases when it stated that such a shift "would raise serious constitutional questions." *Duquesne*, 488 U.S. at 315. And as explained above, TELRIC surely presents, at a minimum, serious questions of confiscation of incumbents' property.

Thus, assuming *arguendo* that there are two permissible readings of the words "the cost . . . of providing the . . . network element" in section 252(d)(1), this Court must choose

the more inclusive reading of the phrase that raises no constitutional difficulties. The fact that the FCC has chosen the narrow reading of "cost" as only "economic cost" should bear no weight in the Court's analysis. Federal courts do not defer to constitutionally problematic agency interpretations of statutes. Indeed, as this Court recently emphasized, "[w]here an administrative interpretation of a statute invokes the outer limits of Congress' power, we expect a clear indication that Congress intended that result." *Solid Waste Agency v. U.S. Army Corps of Eng'rs*, 121 S. Ct. 675, 683 (2001). In other words, there must be an exceedingly clear statement of *congressional* desire to test constitutional limits. *See id.* ("Congress does not casually authorize administrative agencies to interpret a statute to push the limit of congressional authority."); *NLRB v. Catholic Bishop*, 440 U.S. 490, 506-07 (1979). Thus, in order to sustain TELRIC, the FCC must demonstrate that Congress dictated the exclusion of historical costs from network-element prices. This is a burden that the agency cannot sustain. To the contrary, the FCC has stated that the statute "does not specify whether historical or embedded costs should be considered or whether only forward-looking costs should be considered" in setting prices for network elements. J.A. 398-99 (¶ 705). This concession precludes a finding of the kind of clarity demanded by *Solid Waste* and *Catholic Bishop*.

To sidestep the principle of constitutional avoidance, both the FCC and the court below have pointed to *United States v. Riverside Bayview Homes, Inc.*, 474 U.S. 121 (1985), as if that case established some general exemption from the principle of avoidance whenever the constitutional issue at stake involves the Takings Clause. That is simply false. *See, e.g.*, *United States v. Security Indus. Bank*, 459 U.S. 70 (1982).

Riverside Bayview involved an agency interpretation of a statute that, even if applied, would not necessarily have effected a taking of property. The Court held only that a narrowing construction is not warranted if there is no "substantial argument" that application of a statute "will necessarily or even probably constitute a taking" in an "identifiable set of

instances." *Riverside Bayview*, 474 U.S. at 129 n.5. That analysis is inapposite here. Here, incumbents are being forced to turn over pieces of their networks to competitors, a requirement that plainly accomplishes a taking of their property. The only question is whether the rates paid by competitors will provide constitutionally sufficient compensation to ensure that there is not an *uncompensated* taking. Indeed, one factor driving the Court's analysis in *Riverside Bayview* – the availability of a Tucker Act proceeding to provide compensation for any taking – is particularly inapplicable here because Congress clearly intended network-element rates in themselves to provide compensation, not to create liability for the government under the Tucker Act. In a case such as this, as the D.C. Circuit has explained, a narrowing construction is demanded to ensure that the FCC does not "use statutory silence or ambiguity to expose the Treasury to liability both massive and unforeseen." *Bell Atlantic Tel. Cos. v. FCC*, 24 F.3d 1441, 1445 (D.C. Cir. 1994).

III. THE FCC'S DECISION TO ABANDON HISTORICAL COSTS WAS CONTRARY TO THE PURPOSES OF THE ACT AND ARBITRARY AND CAPRICIOUS.

Apart from its constitutional infirmities, the FCC's resort to TELRIC rested on two fundamentally flawed determinations that undermined the purposes of the Act and that the FCC wholly failed to support with reasoned explanations.

A. Abandoning Historical Costs Frustrated Congressional Objectives and Was Not Supported By Any Rational Explanation.

For decades, historical costs have been used for determining the rates incumbent LECs receive for dedicating their property for public use. Indeed, the FCC itself has "strongly espoused" "the original-cost . . . principle of ratemaking . . . for many years." James C. Bonbright *et al.*, *Principles of Public Utility Rates* 212 (2d ed. 1988). Only two years before inventing TELRIC, in fact, the FCC had rejected a replacement cost methodology for cable television rates and explained that

"[o]riginal cost is the normal, now traditional method used for public utility valuation." *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation*, Report & Order and Further Notice of Proposed Rulemaking, 9 F.C.C.R. 4527, 4555, ¶ 55 (1994). In that order, the FCC heaped criticisms upon replacement cost methodologies, charging that they are "speculative," "contentious," "unwieldy," "difficult to apply consistently," "likely to produce ratebase values that would not generate reasonable rates," "unworkable," and conducive to "a contentious exercise in competing opinions." *Id.* ¶¶ 55, 62.

Such criticisms are hardly new. Justice Brandeis long ago observed that replacement cost methodologies are administratively unworkable because they degenerate into battles between experts who give opinions "on things that never happened and estimates requiring the projection of the engineer's imagination into the future and methods of construction and installation that have never been and never will be adopted by sane men." *Missouri ex rel. Southwestern Bell Tel. v. Public Serv. Comm'n*, 262 U.S. 276, 300 (1923) (Brandeis, J., joined by Holmes, J., concurring); *see also* Hon. Stephen Breyer, *Regulation and Its Reform* 38-39 (1982) ("[T]o determine the replacement cost of a plant or equipment is too complex a task for an administrative process.").

The FCC's own experience abundantly confirms that TELRIC is an unmanageable project. In the parallel universal service proceeding, the agency repeatedly concluded that there simply were no cost models accurate enough to implement TELRIC. Only after *four years* of revising and updating various cost models did the agency finally decide that TELRIC could be used to project costs accurately. *See* Universal Service Order ¶¶ 244-245; *Federal-State Joint Board on Universal Service*, Fifth Report & Order, 13 F.C.C.R. 21,323, ¶¶ 3, 60 (1998). And even then the FCC was endorsing TELRIC solely for determining relative cost comparisons for purposes of federal universal service support, and admitted that figures from its TELRIC model "may not be appropriate . . . for other purposes, such as determining prices for unbundled

network elements." *See Federal-State Joint Board on Universal Service*, Ninth Report & Order, 14 F.C.C.R. 20,432, ¶ 41 & n. 125 (1999).

A novel cost measure that, if applied with any care, necessarily entails such difficulties in implementation frustrates one of the important objectives of the Act – namely, the "expeditious introduction of competition." *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 425 (1999) (Breyer, J., concurring in part and dissenting in part). Congress made it clear that it intended the Act to be implemented swiftly. *See* 47 U.S.C. § 251(d)(1); *id.* § 252(b)(1), (e)(4). Saddling that process with the burdens of implementing a novel price measure such as TELRIC necessarily would frustrate the goal of speeding the transition to competition.

The same problems with TELRIC – *i.e.*, the abrupt change it entailed from the established historical cost methodology, the FCC's own criticisms of replacement-cost methodologies, and the agency's inability to find a satisfactory mechanism for implementing the cost measure for four years – also show that the agency was *at least* required to provide a cogent explanation for its decision to abandon historical costs in favor of TELRIC. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 57 (1983).

But the only reasons the agency gave were wholly inadequate. To start, the FCC's only stated reason for dismissing prior concerns about the workability of forward-looking cost measures was that "a number of states" had "already implemented" forward-looking measures for setting UNE prices. J.A. 381 (¶ 681). To the extent that the States cited had adopted forward-looking methodologies applicable to UNE pricing at all, they had done so in principle and had made little progress toward implementing the methodologies by determining costs. This dearth of real-world experience hardly provided a sound basis for the FCC to conclude that TELRIC was practicable.[18]

[18] *See, e.g.*, Bottleneck Servs. Establishment of a Framework for Network Architecture Development of Dominant Carrier Networks, Slip Op., R.93-04-003, I.93-04-002, Dec. 95-12-016, 62 CPUC2d 575 (Cal. PUC Dec. 6, 1995); *Proposed Rules Regarding Implementation of §§ 40-15-101 et seq. - Requirements Relating to Interconnection and Unbundling, Decision Adopting Rules*, Docket No. 95R-556T, Decision No. C96-347 (Colo. PUC Mar. 29, 1996).

The FCC also claimed that basing prices on incumbents' historical costs would promote "inefficient" entry because incumbents' costs reflected inefficiencies. But that assertion was wholly conclusory. Under prevailing regulations, incumbents' costs were either reviewed in the past to ensure that recovery was calibrated to prudent investments, or else they were regulated under price cap regimes that reduced rates according to projections of achievable efficiencies. In either case, simply assuming now that incumbents' costs are riddled with inefficiencies runs counter to the determinations inherent in the existing rate regime. The FCC cannot simply reject those determinations without providing any rationale for its change in course. Not only was such an approach arbitrary, but it also raises a serious due process concern, because changes in rate regimes that alter the basis for a firm's recovery demand procedural due process protections. *See, e.g., West v. Chesapeake & Potomac Tel. Co.*, 295 U.S. 662 (1935).

Moreover, the agency's blithe assumptions about supposed incumbent inefficiency are inconsistent with the FCC's own contemporaneous position that price-cap regulation of rates was providing proper incentives for incumbents to operate efficiently. For a decade, the FCC has taken the view that it has been ensuring efficiency by reducing incumbents' rates by a productivity factor reflecting efficiency savings that reasonably could be achieved. Indeed, less than a year after announcing TELRIC, the FCC concluded that a rate reduction of 6.5 percent would reflect reasonable efficiency gains for incumbents. *See In re Price Cap Performance Review for Local Exchange Carriers*, Fourth Report & Order, 12 F.C.C.R. 16,642, ¶ 1 (1997), *rev'd in part, USTA v. FCC*, 188 F.3d 521, 526-27 (D.C. Cir. 1999) (striking down even 6.5% as

unjustifiedly high). That squarely contradicts the implication, inherent in the adoption of hypothetical TELRIC projections, that 50% discounts from incumbents' costs are necessary to reflect efficient levels.

B. The FCC's Effort To "Mimic" Competitive Outcomes Frustrates the Purposes of the Act.

The very goal the FCC set for itself in TELRIC – attempting to project the costs of an impossibly idealized, least-cost, most-efficient carrier – frustrated the objectives of the Act by short-circuiting the *process* of competition the Act was intended to set in motion. Congress envisioned a system in which entrants achieved efficiencies and introduced innovations that gradually created the genuine benefits of a competitive market, not a system that decreed the supposed benefits of competition (lower prices) by regulatory fiat. As Justice Breyer has noted:

> The competition that the Act seeks is a process, not an end result; and a regulatory system that imposes through administrative mandate a set of prices that tries to mimic those that competition would have set does not thereby become any the less a regulatory process, nor any the more a competitive one.

AT&T Corp., 525 U.S. at 424 (Breyer, J., concurring in part and dissenting in part).

The FCC's economic rationales for TELRIC also suffered from further flaws. *First*, even if it were correct that prices should reflect an accurate measure of forward-looking costs, incumbents' historical costs – the amounts actually expended in building the network – are a far better measure of those costs than is TELRIC. As will be explained in our brief in response to the FCC's appeal in No. 00-587, TELRIC's false assumptions about how any market would work result in unrealistic projections even as a forward-looking cost methodology.

Second, the FCC provided no basis for its assertions that prices based on historical costs would foster "inefficient" entry. Beyond its unexplained assumption that incumbents were inefficient, the FCC offered no reason to explain why, even if

historical-cost prices were higher, inefficient competitors would be induced to enter the market. A potential entrant would evaluate its prospects of competing not only against the incumbent, but also against its best estimate of efficient competing entrants.

Third, the FCC ignored the threat to genuine competition from UNE prices that are too *low*. If prices are too low – as they are with TELRIC's unattainable assumptions – network elements become an irresistible option for entrants and will choke off facilities-based entry. It would be irrational for entrants to deploy new facilities if they could purchase UNEs at prices below any costs they could hope to achieve.

Finally, as Professor Kahn has explained, the FCC ignored a further compelling efficiency reason for *retaining* the historical-cost method: "Entirely apart from the inescapable question of equity that [denying recovery of historical costs] would raise, it is a reasonable economic (as well, perhaps, as constitutional) question whether a market system can survive if governments feel free opportunistically to change the rules of the regulatory game at the expense of investors, when it is temporarily to the advantage of consumers to do so." Declaration of Alfred E. Kahn and Timothy J. Tardiff, ¶ 13, J.A. 160-61, submitted with Reply Comments of Bell Atlantic, *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98 (filed May 30, 1996). Investments made today under a TELRIC pricing regime will become tomorrow's sunk, historical investments, and as one of AT&T's own economists concedes, the failure to allow recovery of stranded historical costs can produce "disincentive[s] for future investment." William J. Baumol & J. Gregory Sidak, *Stranded Costs*, 18 Harv. J.L. & Pub. Pol'y 835, 836 (1995).

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed insofar as it permitted the FCC to preclude recovery of historical costs under section 252(d)(1).

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ADDENDUM

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SEC. 251. [47 U.S.C. 251] INTERCONNECTION.

(a) GENERAL DUTY OF TELECOMMUNICATIONS CARRIERS.–Each telecommunications carrier has the duty–

(1) to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers; and

(2) not to install network features, functions, or capabilities that do not comply with the guidelines and standards established pursuant to section 255 or 256.

(b) OBLIGATIONS OF ALL LOCAL EXCHANGE CARRIERS.–Each local exchange carrier has the following duties:

(1) RESALE.–The duty not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of its telecommunications services.

(2) NUMBER PORTABILITY.–The duty to provide, to the extent technically feasible, number portability in accordance with requirements prescribed by the Commission.

(3) DIALING PARITY.–The duty to provide dialing parity to competing providers of telephone exchange service and telephone toll service, and the duty to permit all such providers to have nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

(4) ACCESS TO RIGHTS-OF-WAY.–The duty to afford access to the poles, ducts, conduits, and rights-of-way of such carrier to competing providers of telecommunications services on rates, terms, and conditions that are consistent with section 224.

(5) RECIPROCAL COMPENSATION.–The duty to establish reciprocal compensation arrangements for the transport and termination of telecommunications.

(c) ADDITIONAL OBLIGATIONS OF INCUMBENT LOCAL EXCHANGE CARRIERS.–In addition to the duties contained in subsection (b), each incumbent local exchange carrier has the following duties:

(1) DUTY TO NEGOTIATE.–The duty to negotiate in good faith in accordance with section 252 the particular terms and conditions of agreements to fulfill the duties described in paragraphs (1) through (5) of subsection (b) and this subsection. The requesting telecommunications carrier also has the duty to negotiate in good faith the terms and conditions of such agreements.

(2) INTERCONNECTION.–The duty to provide, for the facilities and equipment of any requesting telecommunications carrier, interconnection with the local exchange carrier's network–

(A) for the transmission and routing of telephone exchange service and exchange access;

(B) at any technically feasible point within the carrier's network;

(C) that is at least equal in quality to that provided by the local exchange carrier to itself or to any subsidiary, affiliate, or any other party to which the carrier provides interconnection; and

(D) on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, in accordance with the terms and conditions of the agreement and the requirements of this section and section 252.

(3) UNBUNDLED ACCESS.–The duty to provide, to any requesting telecommunications carrier for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis at any technically feasible point on rates, terms, and conditions that are just, reasonable, and nondiscriminatory in accordance with the terms and conditions of the agreement and the requirements of this section and section 252. An incumbent local exchange carrier shall provide such unbundled network elements in a manner that allows requesting carriers to combine such elements in order to provide such telecommunications service.

(4) RESALE.–The duty–

(A) to offer for resale at wholesale rates any telecommunications service that the carrier provides at retail to subscribers who are not telecommunications carriers; and

(B) not to prohibit, and not to impose unreasonable or discriminatory conditions or limitations on, the resale of such telecommunications service, except that a State commission may, consistent with regulations prescribed by the Commission under this section, prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers.

(5) NOTICE OF CHANGES.–The duty to provide reasonable public notice of changes in the information necessary for the transmission and routing of services using that local exchange carrier's facilities or networks, as well as of any other changes that would

affect the interoperability of those facilities and networks.

(6) COLLOCATION.–The duty to provide, on rates, terms, and conditions that are just, reasonable, and nondiscriminatory, for physical collocation of equipment necessary for interconnection or access to unbundled network elements at the premises of the local exchange carrier, except that the carrier may provide for virtual collocation if the local exchange carrier demonstrates to the State commission that physical collocation is not practical for technical reasons or because of space limitations.

(d) IMPLEMENTATION.–

(1) IN GENERAL.–Within 6 months after the date of enactment of the Telecommunications Act of 1996, the Commission shall complete all actions necessary to establish regulations to implement the requirements of this section.

(2) ACCESS STANDARDS.–In determining what network elements should be made available for purposes of subsection (c)(3), the Commission shall consider, at a minimum, whether–

(A) access to such network elements as are proprietary in nature is necessary; and

(B) the failure to provide access to such network elements would impair the ability of the telecommunications carriers seeking access to provide the services that it seeks to offer.

(3) PRESERVATION OF STATE ACCESS REGULATIONS.–In prescribing and enforcing regulations to implement the requirements of this section, the Commission shall not preclude the enforcement of any regulation, order, or policy of a State commission that–

(A) establishes access and interconnection obligations of local exchange carriers;

(B) is consistent with the requirements of this section; and

(C) does not substantially prevent implementation of the requirements of this section and the purposes of this part.

(e) NUMBERING ADMINISTRATION.–

(1) COMMISSION AUTHORITY AND JURISDICTION.–The Commission shall create or designate one or more impartial entities to administer telecommunications numbering and to make such numbers available on an equitable basis. The Commission shall have exclusive jurisdiction over those portions of the North American Numbering Plan that pertain to the United States. Nothing in this paragraph shall preclude the Commission from delegating to State commissions or other entities all or any portion of such jurisdiction.

(2) COSTS.–The cost of establishing telecommunications numbering administration arrangements and number portability shall be borne by all telecommunications carriers on a competitively neutral basis as determined by the Commission.

(f) EXEMPTIONS, SUSPENSIONS, AND MODIFICATIONS.–

(1) EXEMPTION FOR CERTAIN RURAL TELEPHONE COMPANIES.–

(A) EXEMPTION.–Subsection (c) of this section shall not apply to a rural telephone company until (i) such company has received a bona fide request for interconnection, services, or network elements, and (ii) the State commission determines (under subparagraph

(B)) that such request is not unduly economically burdensome, is technically feasible, and is consistent with section 254 (other than subsections (b)(7) and (c)(1)(D) thereof).

(B) STATE TERMINATION OF EXEMPTION AND IMPLEMENTATION SCHEDULE.–The party making a bona fide request of a rural telephone company for interconnection, services, or network elements shall submit a notice of its request to the State commission. The State commission shall conduct an inquiry for the purpose of determining whether to terminate the exemption under subparagraph (A). Within 120 days after the State commission receives notice of the request, the State commission shall terminate the exemption if the request is not unduly economically burdensome, is technically feasible, and is consistent with section 254 (other than subsections (b)(7) and (c)(1)(D) thereof). Upon termination of the exemption, a State commission shall establish an implementation schedule for compliance with the request that is consistent in time and manner with Commission regulations.

(C) LIMITATION ON EXEMPTION.–The exemption provided by this paragraph shall not apply with respect to a request under subsection (c) from a cable operator providing video programming, and seeking to provide any telecommunications service, in the area in which the rural telephone company provides video programming. The limitation contained in this subparagraph shall not apply to a rural

telephone company that is providing video programming on the date of enactment of the Telecommunications Act of 1996.

(2) SUSPENSIONS AND MODIFICATIONS FOR RURAL CARRIERS.–A local exchange carrier with fewer than 2 percent of the Nation's subscriber lines installed in the aggregate nationwide may petition a State commission for a suspension or modification of the application of a requirement or requirements of subsection (b) or (c) to telephone exchange service facilities specified in such petition. The State commission shall grant such petition to the extent that, and for such duration as, the State commission determines that such suspension or modification–

(A) is necessary–

(i) to avoid a significant adverse economic impact on users of telecommunications services generally;

(ii) to avoid imposing a requirement that is unduly economically burdensome; or

(iii) to avoid imposing a requirement that is technically infeasible; and

(B) is consistent with the public interest, convenience, and necessity.

The State commission shall act upon any petition filed under this paragraph within 100 days after receiving such petition. Pending such action, the State commission may suspend enforcement of the requirement or requirements to which the petition applies with respect to the petitioning carrier or carriers.

(g) CONTINUED ENFORCEMENT OF EXCHANGE ACCESS AND INTERCONNECTION REQUIREMENTS.–On and after the date

of enactment of the Telecommunications Act of 1996, each local exchange carrier, to the extent that it provides wireline services, shall provide exchange access information access, and exchange services for such access to interexchange carriers and information service providers in accordance with the same equal access and nondiscriminatory interconnection restrictions and obligations (including receipt of compensation) that apply to such carrier on the date immediately preceding the date of enactment of the Telecommunications Act of 1996 under any court order, consent decree, or regulation, order, or policy of the Commission, until such restrictions and obligations are explicitly superseded by regulations prescribed by the Commission after such date of enactment. During the period beginning on such date of enactment and until such restrictions and obligations are so superseded, such restrictions and obligations shall be enforceable in the same manner as regulations of the Commission.

(h) DEFINITION OF INCUMBENT LOCAL EXCHANGE CARRIER.–

(1) DEFINITION.–For purposes of this section, the term "incumbent local exchange carrier" means, with respect to an area, the local exchange carrier that–

(A) on the date of enactment of the Telecommunications Act of 1996, provided telephone exchange service in such area; and

(B)(i) on such date of enactment, was deemed to be a member of the exchange carrier association pursuant to section 69.601(b) of the Commission's regulations (47 C.F.R. 69.601(b)); or

(ii) is a person or entity that, on or after such date of enactment, became a successor or assign of a member described in clause (i).

(2) TREATMENT OF COMPARABLE CARRIERS AS INCUMBENTS.–The Commission may, by rule, provide for treatment of a local exchange carrier (or class or category thereof) as an incumbent local exchange carrier for purposes of this section if–

(A) such carrier occupies a position in the market for telephone exchange service within an area that is comparable to the position occupied by a carrier described in paragraph (1);

(B) such carrier has substantially replaced an incumbent local exchange carrier described in paragraph (1); and

(C) such treatment is consistent with the public interest, convenience, and necessity and the purposes of this section.

(i) SAVINGS PROVISION.–Nothing in this section shall be construed to limit or otherwise affect the Commission's authority under section 201.

SEC. 252. [47 U.S.C. 252] PROCEDURES FOR NEGOTIATION, ARBITRATION, AND APPROVAL OF AGREEMENTS.

(a) AGREEMENTS ARRIVED AT THROUGH NEGOTIATION.–

(1) VOLUNTARY NEGOTIATIONS.–Upon receiving a request for interconnection, services, or network elements pursuant to section 251, an incumbent local exchange carrier may negotiate and enter into a binding agreement with the requesting telecommunications carrier or carriers without regard to the standards set forth in subsections (b) and (c) of section 251. The agreement shall include a detailed schedule of itemized charges for interconnection and

each service or network element included in the agreement. The agreement, including any interconnection agreement negotiated before the date of enactment of the Telecommunications Act of 1996, shall be submitted to the State commission under subsection (e) of this section.

(2) MEDIATION.–Any party negotiating an agreement under this section may, at any point in the negotiation, ask a State commission to participate in the negotiation and to mediate any differences arising in the course of the negotiation.

(b) AGREEMENTS ARRIVED AT THROUGH COMPULSORY ARBITRATION.–

(1) ARBITRATION.–During the period from the 135th to the 160th day (inclusive) after the date on which an incumbent local exchange carrier receives a request for negotiation under this section, the carrier or any other party to the negotiation may petition a State commission to arbitrate any open issues.

(2) DUTY OF PETITIONER.–

(A) A party that petitions a State commission under paragraph (1) shall, at the same time as it submits the petition, provide the State commission all relevant documentation concerning–

(i) the unresolved issues;

(ii) the position of each of the parties with respect to those issues; and

(iii) any other issue discussed and resolved by the parties.

(B) A party petitioning a State commission under paragraph (1) shall provide a copy of the petition and any documentation to the other party or parties not later than the day

on which the State commission receives the petition.

(3) OPPORTUNITY TO RESPOND.–A non-petitioning party to a negotiation under this section may respond to the other party's petition and provide such additional information as it wishes within 25 days after the State commission receives the petition.

(4) ACTION BY STATE COMMISSION.–

(A) The State commission shall limit its consideration of any petition under paragraph (1) (and any response thereto) to the issues set forth in the petition and in the response, if any, filed under paragraph (3).

(B) The State commission may require the petitioning party and the responding party to provide such information as may be necessary for the State commission to reach a decision on the unresolved issues. If any party refuses or fails unreasonably to respond on a timely basis to any reasonable request from the State commission, then the State commission may proceed on the basis of the best information available to it from whatever source derived.

(C) The State commission shall resolve each issue set forth in the petition and the response, if any, by imposing appropriate conditions as required to implement subsection (c) upon the parties to the agreement, and shall conclude the resolution of any unresolved issues not later than 9 months after the date on which the local exchange carrier received the request under this section.

(5) REFUSAL TO NEGOTIATE.–The refusal of any other party to the negotiation to participate further in the

negotiations, to cooperate with the State commission in carrying out its function as an arbitrator, or to continue to negotiate in good faith in the presence, or with the assistance, of the State commission shall be considered a failure to negotiate in good faith.

(c) STANDARDS FOR ARBITRATION.–In resolving by arbitration under subsection (b) any open issues and imposing conditions upon the parties to the agreement, a State commission shall–

(1) ensure that such resolution and conditions meet the requirements of section 251, including the regulations prescribed by the Commission pursuant to section 251;

(2) establish any rates for interconnection, services, or network elements according to subsection (d); and

(3) provide a schedule for implementation of the terms and conditions by the parties to the agreement.

(d) PRICING STANDARDS.–

(1) INTERCONNECTION AND NETWORK ELEMENT CHARGES.–Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section–

(A) shall be–

(i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and

(ii) nondiscriminatory, and

(B) may include a reasonable profit.

(2) CHARGES FOR TRANSPORT AND TERMINATION OF TRAFFIC.–

(A) IN GENERAL.–For the purposes of compliance by an incumbent local exchange carrier with section 251(b)(5), a State commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless–

(i) such terms and conditions provide for the mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier; and

(ii) such terms and conditions determine such costs on the basis of a reasonable approximation of the additional costs of terminating such calls.

(B) RULES OF CONSTRUCTION.–This paragraph shall not be construed–

(i) to preclude arrangements that afford the mutual recovery of costs through the offsetting of reciprocal obligations, including arrangements that waive mutual recovery (such as bill-and-keep arrangements); or

(ii) to authorize the Commission or any State commission to engage in any rate regulation proceeding to establish with particularity the

additional costs of transporting or terminating calls, or to require carriers to maintain records with respect to the additional costs of such calls.

(3) WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES.–For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunication service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

(e) APPROVAL BY STATE COMMISSION.–

(1) APPROVAL REQUIRED.–Any interconnection agreement adopted by negotiation or arbitration shall be submitted for approval to the State commission. A State commission to which anagreement is submitted shall approve or reject the agreement, with written findings as to any deficiencies.

(2) GROUNDS FOR REJECTION.–The State commission may only reject–

(A) an agreement (or any portion thereof) adopted by negotiation under subsection (a) if it finds that–

(i) the agreement (or portion thereof) discriminates against a telecommunications carrier not a party to the agreement; or

(ii) the implementation of such agreement or portion is not consistent with the public interest, convenience, and necessity; or

(B) an agreement (or any portion thereof) adopted by arbitration under subsection

(b) if it finds that the agreement does not meet the requirements of section 251, including the regulations prescribed by the Commission pursuant to section 251, or the standards set forth in subsection (d) of this section.

(3) PRESERVATION OF AUTHORITY.–Notwithstanding paragraph (2), but subject to section 253, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of an agreement, including requiring compliance with intrastate telecommunications service quality standards or requirements.

(4) SCHEDULE FOR DECISION.–If the State commission does not act to approve or reject the agreement within 90 days after submission by the parties of an agreement adopted by negotiation under subsection (a), or within 30 days after submission by the parties of an agreement adopted by arbitration under subsection (b), the agreement shall be deemed approved. No State court shall have jurisdiction to review the action of a State commission in approving or rejecting an agreement under this section.

(5) COMMISSION TO ACT IF STATE WILL NOT ACT.–If a State commission fails to act to carry out its responsibility under this section in any proceeding or other matter under this section, then the Commission shall issue an order preempting the State commission's jurisdiction of that proceeding or matter within 90 days after being notified (or taking notice) of such failure, and shall assume the responsibility of the State commission under this section with respect to the proceeding or matter and act for the State commission.

(6) REVIEW OF STATE COMMISSION ACTIONS.–In a case in which a State fails to act as described in paragraph (5), the proceeding by the Commission under such paragraph and any judicial review of the Commission's actions shall be the exclusive remedies for a State commission's failure to act. In any case in which a State commission makes a determination under this section, any party aggrieved by such determination may bring an action in an appropriate Federal district court to determine whether the agreement or statement meets the requirements of section 251 and this section.

(f) STATEMENTS OF GENERALLY AVAILABLE TERMS.–

(1) IN GENERAL.–A Bell operating company may prepare and file with a State commission a statement of the terms and conditions that such company generally offers within that State to comply with the requirements of section 251 and the regulations thereunder and the standards applicable under this section.

(2) STATE COMMISSION REVIEW.–A State commission may not approve such statement unless such statement complies with subsection (d) of this section and section 251 and the regulations thereunder. Except as provided in section 253, nothing in this section shall prohibit a State commission from establishing or enforcing other requirements of State law in its review of such statement, including requiring compliance with intrastate telecommunications service quality standards or requirements.

(3) SCHEDULE FOR REVIEW.–The State commission to which a statement is submitted shall, not later than 60 days after the date of such submission–

(A) complete the review of such statement under paragraph (2) (including any reconsideration thereof), unless the submitting

carrier agrees to an extension of the period for such review; or

(B) permit such statement to take effect.

(4) AUTHORITY TO CONTINUE REVIEW.–Paragraph (3) shall not preclude the State commission from continuing to review a statement that has been permitted to take effect under subparagraph (B) of such paragraph or from approving or disapproving such statement under paragraph (2).

(5) DUTY TO NEGOTIATE NOT AFFECTED.–The submission or approval of a statement under this subsection shall not relieve a Bell operating company of its duty to negotiate the terms and conditions of an agreement under section 251.

(g) CONSOLIDATION OF STATE PROCEEDINGS.–Where not inconsistent with the requirements of this Act, a State commission may, to the extent practical, consolidate proceedings under sections 214(e), 251(f), 253, and this section in order to reduce administrative burdens on telecommunications carriers, other parties to the proceedings, and the State commission in carrying out its responsibilities under this Act.

(h) FILING REQUIRED.–A State commission shall make a copy of each agreement approved under subsection (e) and each statement approved under subsection (f) available for public inspection and copying within 10 days after the agreement or statement is approved. The State commission may charge a reasonable and nondiscriminatory fee to the parties to the agreement or the party filing the statement to cover the costs of approving and filing such agreement or statement.

(i) AVAILABILITY TO OTHER TELECOMMUNICATIONS CARRIERS.–A local exchange carrier shall make available any interconnection, service, or network element provided under an

agreement approved under this section to which it is a party to any other requesting telecommunications carrier upon the same terms and conditions as those provided in the agreement.

(j) DEFINITION OF INCUMBENT LOCAL EXCHANGE CARRIER.–For purposes of this section, the term "incumbent local exchange carrier" has the meaning provided in section 251(h).

SEC. 253. [47 U.S.C. 253] REMOVAL OF BARRIERS TO ENTRY.

(a) IN GENERAL.–No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service.

(b) STATE REGULATORY AUTHORITY.–Nothing in this section shall affect the ability of a State to impose, on a competitively neutral basis and consistent with section 254 of this section, requirements necessary to preserve and advance universal service, protect the public safety and welfare, ensure the continued quality of telecommunications services, and safeguard the rights of consumers.

(c) STATE AND LOCAL GOVERNMENT AUTHORITY.–Nothing in this section affects the authority of a State or local government to manage the public rights-of-way or to require fair and reasonable compensation from telecommunications providers, on a competitively neutral and nondiscriminatory basis, for use of public rights-of-way on a nondiscriminatory basis, if the compensation required is publicly disclosed by such government.

(d) PREEMPTION.–If, after notice and an opportunity for public comment, the Commission determines that a State or local government has permitted or imposed any statute, regulation, or legal requirement that violates subsection (a) or

(b) of this section, the Commission shall preempt the enforcement of such statute, regulation, or legal requirement to the extent necessary to correct such violation or inconsistency.

(e) COMMERCIAL MOBILE SERVICE PROVIDERS.–Nothing in this section shall affect the application of section 332(c)(3) of this title to commercial mobile service providers.

(f) RURAL MARKETS.–It shall not be a violation of this section for a State to require a telecommunications carrier that seeks to provide telephone exchange service or exchange access in a service area served by a rural telephone company to meet the requirements in section 214(e)(1) of this title for designation as an eligible telecommunications carrier for that area before being permitted to provide such service. This subsection shall not apply–

(1) to a service area served by a rural telephone company that has obtained an exemption, suspension, or modification of section 251(c)(4) of this title that effectively prevents a competitor from meeting the requirements of section 214(e)(1) of this title; and

(2) to a provider of commercial mobile services.

SEC. 254. [47 U.S.C. 254] UNIVERSAL SERVICE.

(a) PROCEDURES TO REVIEW UNIVERSAL SERVICE REQUIREMENTS.–

(1) FEDERAL-STATE JOINT BOARD ON UNIVERSAL SERVICE.–Within one month after February 8, 1996, the Commission shall institute and refer to a Federal-State Joint Board under section 410(c) of this title a proceeding to recommend changes to any of its regulations in order to implement sections 214(e) of this title and this section, including the definition of the services that are supported by Federal universal service

support mechanisms and a specific timetable for completion of such recommendations. In addition to the members of the Joint Board required under section 410(c) of this title, one member of such Joint Board shall be a State-appointed utility consumer advocate nominated by a national organization of State utility consumer advocates. The Joint Board shall, after notice and opportunity for public comment, make its recommendations to the Commission 9 months after February 8, 1996.

(2) COMMISSION ACTION.–The Commission shall initiate a single proceeding to implement the recommendations from the Joint Board required by paragraph (1) and shall complete such proceeding within 15 months after February 8, 1996. The rules established by such proceeding shall include a definition of the services that are supported by Federal universal service support mechanisms and a specific timetable for implementation. Thereafter, the Commission shall complete any proceeding to implement subsequent recommendations from any Joint Board on universal service within one year after receiving such recommendations.

(b) UNIVERSAL SERVICE PRINCIPLES.–The Joint Board and the Commission shall base policies for the preservation and advancement of universal service on the following principles:

(1) QUALITY AND RATES.–Quality services should be available at just, reasonable, and affordable rates.

(2) ACCESS TO ADVANCED SERVICES.–Access to advanced telecommunications and information services should be provided in all regions of the Nation.

(3) ACCESS IN RURAL AND HIGH COST AREAS.–Consumers in all regions of the Nation, including low-

income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.

(4) EQUITABLE AND NONDISCRIMINATORY CONTRIBUTIONS.–All providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service.

(5) SPECIFIC AND PREDICTABLE SUPPORT MECHANISMS.–There should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service.

(6) ACCESS TO ADVANCED TELECOMMUNICATIONS SERVICES FOR SCHOOLS, HEALTH CARE, AND LIBRARIES.–Elementary and secondary schools and classrooms, health care providers, and libraries should have access to advanced telecommunications services as described in subsection (h) of this section.

(7) ADDITIONAL PRINCIPLES.–Such other principles as the Joint Board and the Commission determine are necessary and appropriate for the protection of the public interest, convenience, and necessity and are consistent with this chapter.

(c) DEFINITION.–

(1) IN GENERAL.–Universal service is an evolving level of telecommunications services that the Commission shall establish periodically under this section, taking into account advances in

telecommunications and information technologies and services. The Joint Board in recommending, and the Commission in establishing, the definition of the services that are supported by Federal universal service support mechanisms shall consider the extent to which such telecommunications services–

(A) are essential to education, public health, or public safety;

(B) have, through the operation of market choices by customers, been subscribed to by a substantial majority of residential customers;

(C) are being deployed in public telecommunications networks by telecommunications carriers; and

(D) are consistent with the public interest, convenience, and necessity.

(2) ALTERATIONS AND MODIFICATIONS.–The Joint Board may, from time to time, recommend to the Commission modifications in the definition of the services that are supported by Federal universal service support mechanisms.

(3) SPECIAL SERVICES.–In addition to the services included in the definition of universal service under paragraph (1), the Commission may designate additional services for such support mechanisms for schools, libraries, and health care providers for the purposes of subsection (h) of this section.

(d) TELECOMMUNICATIONS CARRIER CONTRIBUTION.–Every telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service. The

Commission may exempt a carrier or class of carriers from this requirement if the carrier's telecommunications activities are limited to such an extent that the level of such carrier's contribution to the preservation and advancement of universal service would be de minimis. Any other provider of interstate telecommunications may be required to contribute to the preservation and advancement of universal service if the public interest so requires.

(e) UNIVERSAL SERVICE SUPPORT.–After the date on which Commission regulations implementing this section take effect, only an eligible telecommunications carrier designated under section 214(e) of this title shall be eligible to receive specific Federal universal service support. A carrier that receives such support shall use that support only for the provision, maintenance, and upgrading of facilities and services for which the support is intended. Any such support should be explicit and sufficient to achieve the purposes of this section.

(f) STATE AUTHORITY.–A State may adopt regulations not inconsistent with the Commission's rules to preserve and advance universal service. Every telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service in that State. A State may adopt regulations to provide for additional definitions and standards to preserve and advance universal service within that State only to the extent that such regulations adopt additional specific, predictable, and sufficient mechanisms to support such definitions or standards that do not rely on or burden Federal universal service support mechanisms.

(g) INTEREXCHANGE AND INTERSTATE SERVICES.–Within 6 months after February 8, 1996, the Commission shall adopt rules to require that the rates charged by providers of interexchange telecommunications services to

subscribers in rural and high cost areas shall be no higher than the rates charged by each such provider to its subscribers in urban areas. Such rules shall also require that a provider of interstate interexchange telecommunications services shall provide such services to its subscribers in each State at rates no higher than the rates charged to its subscribers in any other State.

(h) TELECOMMUNICATIONS SERVICES FOR CERTAIN PROVIDERS.–

(1) IN GENERAL.–

(A) HEALTH CARE PROVIDERS FOR RURAL AREAS.–A telecommunications carrier shall, upon receiving a bona fide request, provide telecommunications services which are necessary for the provision of health care services in a State, including instruction relating to such services, to any public or nonprofit health care provider that serves persons who reside in rural areas in that State at rates that are reasonably comparable to rates charged for similar services in urban areas in that State. A telecommunications carrier providing service under this paragraph shall be entitled to have an amount equal to the difference, if any, between the rates for services provided to health care providers for rural areas in a State and the rates for similar services provided to other customers in comparable rural areas in that State treated as a service obligation as a part of its obligation to participate in the mechanisms to preserve and advance universal service.

(B) EDUCATIONAL PROVIDERS AND LIBRARIES.–All telecommunications carriers serving a geographic area shall, upon a bona

fide request for any of its services that are within the definition of universal service under subsection (c)(3) of this section, provide such services to elementary schools, secondary schools, and libraries for educational purposes at rates less than the amounts charged for similar services to other parties. The discount shall be an amount that the Commission, with respect to interstate services, and the States, with respect to intrastate services, determine is appropriate and necessary to ensure affordable access to and use of such services by such entities. A telecommunications carrier providing service under this paragraph shall–

(i) have an amount equal to the amount of the discount treated as an offset to its obligation to contribute to the mechanisms to preserve and advance universal service, or

(ii) notwithstanding the provisions of subsection (e) of this section, receive reimbursement utilizing the support mechanisms to preserve and advance universal service.

(2) ADVANCED SERVICES.–The Commission shall establish competitively neutral rules–

(A) to enhance, to the extent technically feasible and economically reasonable, access to advanced telecommunications and information services for all public and nonprofit elementary and secondary school classrooms, health care providers, and libraries; and

(B) to define the circumstances under which a tele-communications carrier may be

required to connect its network to such public institutional telecommunications users.

(3) TERMS AND CONDITIONS.–Telecommunications services and network capacity provided to a public institutional telecommunications user under this subsection may not be sold, resold, or otherwise transferred by such user in consideration for money or any other thing of value.

(4) ELIGIBILITY OF USERS.–No entity listed in this subsection shall be entitled to preferential rates or treatment as required by this subsection, if such entity operates as a for-profit business, is a school described in paragraph (5)(A) with an endowment of more than $50,000,000, or is a library or library consortium not eligible for assistance from a State library administrative agency under the Library Services and Technology Act.

(5) DEFINITIONS.–For purposes of this subsection:

(A) ELEMENTARY AND SECONDARY SCHOOLS.–The term "elementary and secondary schools" means elementary schools and secondary schools, as defined in paragraphs (14) and (25), respectively, of section 8801 of Title 20.

(B) HEALTH CARE PROVIDER.–The term "health care provider" means–

(i) post-secondary educational institutions offering health care instruction, teaching hospitals, and medical schools;

(ii) community health centers or health centers providing health care to migrants;

(iii) local health departments or agencies;

(iv) community mental health centers;

(v) not-for-profit hospitals;

(vi) rural health clinics; and

(vii) consortia of health care providers consisting of one or more entities described in clauses (i) through (vi).

(C) PUBLIC INSTITUTIONAL TELECOMMUNICATIONS USER.–The term "public institutional telecommunications user" means an elementary or secondary school, a library, or a health care provider as those terms are defined in this paragraph.

(i) CONSUMER PROTECTION.–The Commission and the States should ensure that universal service is available at rates that are just, reasonable, and affordable.

(j) LIFELINE ASSISTANCE.–Nothing in this section shall affect the collection, distribution, or administration of the Lifeline Assistance Program provided for by the Commission under regulations set forth in section 69.117 of title 47, Code of Federal Regulations, and other related sections of such title.

(k) SUBSIDY OF COMPETITIVE SERVICES PROHIBITED.–A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition. The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

47 C.F.R. § 51.501 Scope.

(a) The rules in this subpart apply to the pricing of network elements, interconnection, and methods of obtaining access to unbundled elements, including physical collocation and virtual collocation.
(b) As used in this subpart, the term "element" includes network elements, interconnection, and methods of obtaining interconnection and access to unbundled elements.

47 C.F.R. § 51.503 General pricing standard.

(a) An incumbent LEC shall offer elements to requesting telecommunications carriers at rates, terms, and conditions that are just, reasonable, and nondiscriminatory.
(b) An incumbent LEC's rates for each element it offers shall comply with the rate structure rules set forth in §§ 51.507 and 51.509, and shall be established, at the election of the state commission-

(1) Pursuant to the forward-looking economic cost-based pricing methodology set forth in §§ 51.505 and 51.511; or

(2) Consistent with the proxy ceilings and ranges set forth in § 51.513.
(c) The rates that an incumbent LEC assesses for elements shall not vary on the basis of the class of customers served by the requesting carrier, or on the type of services that the requesting carrier purchasing such elements uses them to provide.

47 C.F.R. § 51.505 Forward-looking economic cost.

(a) In general. The forward-looking economic cost of an element equals the sum of:

(1) The total element long-run incremental cost of the element, as described in paragraph (b); and

(2) A reasonable allocation of forward-looking common costs, as described in paragraph (c).
(b) Total element long-run incremental cost. The total element long-run incremental cost of an element is the forward-looking cost over the long run of the total quantity of the facilities and functions that are directly attributable to, or reasonably identifiable as incremental to, such element, calculated taking as a given the incumbent LEC's provision of other elements.

(1) Efficient network configuration. The total element long-run incremental cost of an element should be measured based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration, given the existing location of the incumbent LEC's wire centers.

(2) Forward-looking cost of capital. The forward-looking cost of capital shall be used in calculating the total element long-run incremental cost of an element.

(3) Depreciation rates. The depreciation rates used in calculating forward- looking economic costs of elements shall be economic depreciation rates.
(c) Reasonable allocation of forward-looking common costs--

(1) Forward-looking common costs. Forward-looking common costs are economic costs efficiently incurred in providing a group of elements or services (which may include all elements or services provided by the incumbent LEC) that cannot be attributed directly to individual elements or services.

(2) Reasonable allocation.

(i) The sum of a reasonable allocation of forward-looking common costs and the total element long-run incremental cost of an element shall not exceed the stand-alone costs associated with the element. In this context, stand-alone costs are the total

forward-looking costs, including corporate costs, that would be incurred to produce a given element if that element were provided by an efficient firm that produced nothing but the given element.

(ii) The sum of the allocation of forward-looking common costs for all elements and services shall equal the total forward-looking common costs, exclusive of retail costs, attributable to operating the incumbent LEC's total network, so as to provide all the elements and services offered.

(d) Factors that may not be considered. The following factors shall not be considered in a calculation of the forward-looking economic cost of an element:

(1) Embedded costs. Embedded costs are the costs that the incumbent LEC incurred in the past and that are recorded in the incumbent LEC's books of accounts;

(2) Retail costs. Retail costs include the costs of marketing, billing, collection, and other costs associated with offering retail telecommunications services to subscribers who are not telecommunications carriers, described in § 51.609;

(3) Opportunity costs. Opportunity costs include the revenues that the incumbent LEC would have received for the sale of telecommunications services, in the absence of competition from telecommunications carriers that purchase elements; and

(4) Revenues to subsidize other services. Revenues to subsidize other services include revenues associated with elements or telecommunications service offerings other than the element for which a rate is being established.

(e) Cost study requirements. An incumbent LEC must prove to the state commission that the rates for each element it offers do not exceed the forward- looking economic cost per unit of providing the element, using a cost study that complies with the methodology set forth in this section and § 51.511.

(1) A state commission may set a rate outside the proxy ranges or above the proxy ceilings described in § 51.513 only if that commission has given full and fair effect to the economic cost based pricing methodology described in this section and § 51.511 in a state proceeding that meets the requirements of paragraph (e)(2) of this section.

(2) Any state proceeding conducted pursuant to this section shall provide notice and an opportunity for comment to affected parties and shall result in the creation of a written factual record that is sufficient for purposes of review. The record of any state proceeding in which a state commission considers a cost study for purposes of establishing rates under this section shall include any such cost study.

47 C.F.R. § 51.507 <u>General rate structure standard</u>.

(a) Element rates shall be structured consistently with the manner in which the costs of providing the elements are incurred.

(b) The costs of dedicated facilities shall be recovered through flat-rated charges.

(c) The costs of shared facilities shall be recovered in a manner that efficiently apportions costs among users. Costs of shared facilities may be apportioned either through usage-sensitive charges or capacity-based flat-rated charges, if the state commission finds that such rates reasonably reflect the costs imposed by the various users.

(d) Recurring costs shall be recovered through recurring charges, unless an incumbent LEC proves to a state commission that such recurring costs are de minimis. Recurring costs shall be considered de minimis when the costs of administering the recurring charge would be excessive in relation to the amount of the recurring costs.

(e) State commissions may, where reasonable, require incumbent LECs to recover nonrecurring costs through recurring charges over a reasonable period of time. Nonrecurring charges shall be allocated efficiently among requesting telecommunications carriers, and shall not permit an incumbent LEC to recover more than the total forward-looking economic cost of providing the applicable element.
(f) State commissions shall establish different rates for elements in at least three defined geographic areas within the state to reflect geographic cost differences.

(1) To establish geographically-deaveraged rates, state commissions may use existing density-related zone pricing plans described in § 69.123 of this chapter, or other such cost-related zone plans established pursuant to state law.

(2) In states not using such existing plans, state commissions must create a minimum of three cost-related rate zones.

47 C.F.R § 51.509 Rate structure standards for specific elements.

In addition to the general rules set forth in § 51.507, rates for specific elements shall comply with the following rate structure rules.
(a) Local loops. Loop costs shall be recovered through flat-rated charges.
(b) Local switching. Local switching costs shall be recovered through a combination of a flat-rated charge for line ports and one or more flat-rated or per-minute usage charges for the switching matrix and for trunk ports.
(c) Dedicated transmission links. Dedicated transmission link costs shall be recovered through flat-rated charges.
(d) Shared transmission facilities between tandem switches and end offices. The costs of shared transmission facilities between

tandem switches and end offices may be recovered through usage-sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.
(e) Tandem switching. Tandem switching costs may be recovered through usage- sensitive charges, or in another manner consistent with the manner that the incumbent LEC incurs those costs.
(f) Signaling and call-related database services. Signaling and call-related database service costs shall be usage-sensitive, based on either the number of queries or the number of messages, with the exception of the dedicated circuits known as signaling links, the cost of which shall be recovered through flat- rated charges.
(g) Collocation. Collocation costs shall be recovered consistent with the rate structure policies established in the Expanded Interconnection proceeding, CC Docket No. 91-141.

47 C.F.R. § 51.511 Forward-looking economic cost per unit.

(a) The forward-looking economic cost per unit of an element equals the forward-looking economic cost of the element, as defined in § 51.505, divided by a reasonable projection of the sum of the total number of units of the element that the incumbent LEC is likely to provide to requesting telecommunications carriers and the total number of units of the element that the incumbent LEC is likely to use in offering its own services, during a reasonable measuring period.
(b)(1) With respect to elements that an incumbent LEC offers on a flat-rate basis, the number of units is defined as the discrete number of elements (e.g., local loops or local switch ports) that the incumbent LEC uses or provides.
(2) With respect to elements that an incumbent LEC offers on a usage-sensitive basis, the number of units is defined as the

unit of measurement of the usage (e.g., minutes of use or call-related database queries) of the element.